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THESIS

Capital Gains and Losses as Affected by the Federal Income Tax

by

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(B. S. in B. A. Northeastern University, 1946)

submitted in partial fulfillment of
the requirements for the degree of

MASTER OF BUSINESS ADMINISTRATION

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Chapter I

INTRODUCTION

The taxation of capital gains and losses within the federal income tax has been the subject of much debate and many changes in the law. An explanation of many of the difficulties may be found in this thesis.

A history of the many changes in the law concerning capital gains and losses from the inception of the law to the taxable year 1946 is here presented. Until The year 1921 capital gains and losses were not distinguished from other types of gains and losses for tax purposes. Since the year 1921 the government has distinguished by several different methods of treatment the difference between "Capital" gains and other types of income, and "capital" losses and other types of losses.

The computation of the tax upon capital gains and losses for the taxable year 1946 is presented in detail, with explanations of the law and examples. For the purpose of comparison of the two systems the current British practice is also explained at length, with excerpts from their law, and interpretations of their law by the British courts. Great Britain was singled out in this respect because of the contrast between the United States and British practice in the taxation of capital gains and losses, and the differences in the meanings of the words employed in the laws of these two countries.

Some of the arguments for and against the present treatment in the United States of capital gains and losses are presented. A few of the issues follow:

Should capital gains on assets which were held for a long period of time be treated more favorably than other types of income?

Does capital gains taxation have a deterrent effect upon risk capital, and if so, should we eliminate the tax?

Should capital losses be allowed in full if capital gains are taxed?

Should we emulate the British system of taking no cognizance of capital gains and losses?

It is well to know whence capital gains and losses arise. R.E. Paul, former General Counsel of the Treasury, in an address before the New School, New York City, January 30, 1945 gave the following figures for the typical year 1939. Of the many possible sources of capital gains and losses, stock market operations are by far the most important, accounting for about eighty percent of both such gains and losses. A breakdown of capital gains by income groups follows:

Under $5,000........................Less than 1%

$5,000-$25,000......................Less than 3%

Over $25,000..................................96%

As is indicated by the above figures, capital gains are most important in high income groups. This was further borne out by Mr. Paul in his statement that in 1938 the income class between $100,000 and $1,000,000 per year

reported only 2½% of the aggregate net income but reported 33% of all the capital gains.

From the above figures it might be assumed that any important changes in capital gains and losses taxation would seriously affect stock market transactions, and the income patterns of taxpayers with high incomes.

Persons who are interested in maintaining the progressive nature of the income tax are opposed to granting special favorable concessions to capital gains as they occur largely among persons of high incomes, and because of the many ways that ordinary income can be converted into capital gains. Taxpayers, a large portion of whose incomes consist of capital gains are opposed to any encroachments on tax concessions already gained and seek further tax relief.

CHAPTER II

HISTORY OF THE CAPITAL GAINS AND LOSSES PROVISIONS OF THE FEDERAL INCOME TAX IN THE U.S.

The federal income tax law has operated continuously in the United States with constantly changing [illegible] since March 1, 1913. The subject of an income tax law, however, was not new at that time, as it had been used by several foreign countries, [illegible] and once before in the United States. As this type of [illegible] has been [illegible] in [illegible]. The [illegible] capital gains [illegible] as [illegible] different [illegible] from ordinary income [illegible].

A

[illegible] History of the Capital Gains and Losses Provisions of the Federal Income Tax

During the Civil War, when the need for revenue was great, a graduated income tax law was enacted. The Congress [illegible] a [illegible]. [illegible] definite attempt to set up the tax [illegible] on a [illegible] basis, [illegible] upon the first [illegible]. The income tax law was [illegible] several times between the [illegible] of 1862 and its expiration in 1872. Another income tax law [illegible] 1894, but this was [illegible] in 1895.

Chapter II

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The Federal income tax law has operated continuously in the United States with many periodic changes in content since March 1, 1913. The concept of an income tax law, however, was not new to the world, as it had been used by several foreign countries, notably Great Britain. Nor was it new to the United States, as this type of legislation had been put into effect in earlier years. In almost all of this legislation capital gains were considered as something different and apart from ordinary taxable income.

Early History of the Capital Gains and Losses Provisions of the Federal Income Tax

During the Civil War, when the need was felt for more funds, a graduated income tax was proposed and adopted. The income tax was not simply a fund raising measure, but a definite attempt to set up the tax system on a more equitable basis, with the burden falling more heavily on the industrial States than upon the rural states. The income tax law was revised several times between its inception in 1862 and its expiration in 1870. Another income tax law followed, but this was repealed in 1872.

The Civil War income taxes brought up the problem of capital gains and losses. In 1864, in order to change a ruling of the Commissioner of Internal Revenue on the 1862 tax, Congress limited the taxation of profits upon real estate to that which was purchased during the year. Actual losses from the sale of such property could be deducted from income.[1/]

The income tax of 1867 again changed the capital gains provisions. Profits realized from the sale of real estate purchased a year or two previously were included as income. Loss deductions were limited to the actual loss on real estate purchased during the year, but did not extend to the two year period required for gains. The farmer, in his computation of income for the tax, was required to report the realized gain on sales of livestock, rather than using the previous method of reporting increased value of livestock, sold or unsold.[2/]

From the expiration of the act in 1871 until the passage of a new income law in 1894, there was almost continual agitation from certain groups for the income tax. The rural West and South favored the tax while the industrial East was against it.[3/] The Populists and Democrats in parts of the country other than the East were in favor of the

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1. Ratner, S., op. cit. p. 86.
2. Ibid., op. cit. p. 116
3. Ibid., op. cit. p. 118

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1. Ratner, S., op. cit. p. 96.
2. Ibid., op. cit. p. 116
3. Ibid., op. cit. p. 118

income tax, while the Eastern Democrats and Republicans were against the measure.[1]

The 1894 income tax law was similar in most of its provisions to the Civil War tax.[2] Gains from real estate sales were considered income when the real estate had been purchased within the previous two years.[3] This ill-fated tax was, however, declared unconstitutional by the United States Supreme Court in a famous series of cases.[4]

The court decision was quite naturally unpopular in the ranks of those who had favored the bill and the issue popped up again in the Democratic convention of 1908 where the following plank was adopted: "We favor an income tax as part of our revenue system, and we urge the submission of a constitutional amendment, specifically authorizing Congress to levy and collect the tax upon individual and corporate income. To that end wealth may bear its proportional share of the burdens of the Federal Government."

Cloaked as "A special excise tax with respect to carrying on or doing business by such corporation, joint stock company, or association", a corporation income tax

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1. Ratner, S., ch. 9.
2. Ibid., op. cit. ch. 9.
3. Ibid.
4. Ibid, ch 10

was passed in 1909. Under the provisions of the excise tax, all corporations engaged in business in the United States were subject to an excise tax of 1% of the net income in excess of $5,000 received from all sources, other than dividends from corporations subject to the tax. The constitutionality of a corporation excise tax was tested by a series of cases before the United States Supreme Court. Although the treasury suffered some minor reverses, the law was substantially upheld.

History of the Capital Gains and Losses Provisions of the Federal Income Tax, from 1913 to 1947.

On February 25, 1913 the Sixteenth Amendment to the Constitution was ratified by the required number of states and became the law. The amendment was apparently popular, as it was eventually ratified by practically all the states.[1]

The 1913 income tax law was incorporated as section 2 of the Underwood-Simmons Tariff Act. There were many exemptions and the rates were lower than those of the Civil War. The law defined taxable income as "Gains, profits and income derived from salaries, wages, compensation for personal service ... or from professions, vocations, business, trade, commerce, or sales or dealings in property, whether

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1. 71'st Congress, 3'd session, Senate document 240, U. S. Library of Congress, Legislative Reference Service, Data on Ratification of the Constitution, and Amendment by States, p. 10

real or personal...also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever including the income from but not the value of property acquired by gift, bequest, devise, or descent."[1] When the bill was under consideration the problem of capital gains and losses was disposed of by Cordell Hull's statement that the bill would apply only to purchases and sales made within the same year.[2] This interpretation, however, was not upheld by the Commissioner. Gains of individuals (taxpayers other than corporations) from the sales or exchanges of assets were included with other income subject to full normal and surtax rates, while losses from the sale or exchange of assets were not allowed. Gains of corporations from sale or exchange of assets were included with other income subject to full rate, while losses were allowed in full against income of any kind.

The 1916 revenue act was more progressive in character than the act of 1913. Important changes in many provisions, including capital gains and losses were made. The basis of property for the purposes of determining gain, if the property was acquired before March 1, 1913 was determined by the fair market value of the property on March 1, 1913.

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1. Ratner, S., op. cit. p. 334

2. Ibid., op. cit. p 329

The treatment of capital gains of individuals remained the same as in 1913, but capital losses of individuals from the sale or exchange of assets were allowed only to the extent of the gains from such sales or exchanges. No changes were made in capital gains and losses provisions of corporations, their losses being allowed in full against income of any kind, and gains included with other income taxable at the full rate. The 1917 war revenue act greatly increased the types and rates of taxes for revenue purposes. Although the rates of income taxes rose the basic method of treatment of capital gains and losses remained unaltered for both individuals and corporations. The revenue act was notable, also, for imposing an excess profits tax.

The revenue act of 1918 increased further the load of taxes. At the time it was considered the greatest levy of taxation ever made.[1] The capital loss provision for individuals was eased to the extent of allowing the losses from the sale or exchange of assets to be allowed in full against income of any kind. They had previously beem allowed to taxpayers other than corporations only to the amount of gains from such sales although corporations had been allowed this privilege since 1913. The Supreme Court, in the case of Eisner v. Macomber on March 8, 1920

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1. "Washington Notes", Journal of Political Economy, March 1919, 27: 214.

decided that "neither under the sixteenth amendment or otherwise had Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated promise behind it, as income of the stockholder."[1] The basic treatment of capital gains for individuals and both capital gains and losses for corporations remained otherwise the same as they had been since their inception in 1913.

The 1921 revenue act repealed the excess profits tax of 1917. The act was the cause of many changes in the treatment of capital gains and losses. As has been indicated, capital gains had been taxed on the entire amount in the year of sale, regardless of how long the property had been held. It was attempted to correct this inequity for individual taxpayers by providing an alternative tax of twelve and one half percent in lieu of the normal tax and surtax on capital assets held over two years, providing the total tax was not less than twelve and one half percent of the total net income. This provision favored the taxpayers having a net income of at least $30,000 in which case capital gains above that amount would be taxed at a lower rate than other types of income. A differentiation was made in the rates of taxation depending upon the length of time the asset was held. The gains on an asset held two years or less were included

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1. 252 U.S. 189, 219.

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as ordinary income and subject to full taxation. Losses were similarly allowed in full against other income, but could not be applied against capital gains. The net gains on assets held over two years were subject to the alternative tax above mentioned of twelve and one half percent, while losses from this class of assets were allowed in full against income of any description. Certain refinements in determining whether or not a particular asset was subject to gains and losses, and the basis of such assets, were included in the law. For example, the basis for determining gain or loss of a gift of property acquired after December 31, 1920 was the same as if the last preceding owner had sold it. Under certain types of reorganizations property could be transferred from one corporation to another without tax liabilities. Distribution by corporations not out of earnings accumulated since February 28, 1913 were considered as return of capital and non-taxable, except where the stockholder received more than the basis of his stock.[1] The general rule for corporations remained unchanged, including gains from sale or exchange of assets with other income, subject to full rate; and allowing losses in full against income of any kind.

The revenue act of <u>1924</u> further reduced the rates of income taxes and made further changes in the provisions for

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1. Ratner, S., op. cit., p. 408.

capital gains and losses. Losses of individuals on assets held over two years could no longer be deducted against income of any kind to an unlimited amount. Losses on assets of individuals held over two years could be separated from ordinary net income and a credit against the tax of twelve and a half percent of this capital net loss could be taken provided this produced a tax which was no less than if the net loss were deducted from ordinary income and computed at the regular rates. This prevented taxpayers from using their capital losses to cancel both capital gains and ordinary income, which practice had been observed by the Secretary of the Treasury, Andrew Mellon.[1] As regards capital gains on assets held over two years, any individual taxpayer could elect to tax net gains at twelve and one half percent in lieu of the ordinary tax rate. Capital losses on assets of individuals held two years or less were now allowed in full against income of any kind, with no restrictions against deduction from capital gains. Treatment of capital gains on assets held two years or less, and upon capital gains and losses provisions for corporations remained unchanged.

The 1926 act, it is said, shifted the tax burden from the large taxpayer to the small taxpayer by a change in rates and other provisions.[2] The methods for computation

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1. Treasury Report, 1922, 14.

2. Literary Digest, March 6, 1926, 88: 5-7.

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1. Treasury Report, 1922, 19.

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of capital net gains and losses were not changed from those in 1924, except for a clarification of certain obscure points.[1/]

The revenue act of 1928 further reduced the tax. The method of taxation of capital net gains and losses remained the same as in 1926.

The revenue act of 1932 increased the tax rates and tightened the provisions for capital gains and losses in an attempt to balance the Federal budget. The losses from sale or exchange of stocks and bonds of individuals held two years or less were limited for tax purposes to gains from such sales. These losses of individuals which were disallowed in one year, but were not in excess of net income, could be carried over to the following year and applied against gains on stocks and bonds held two years or less. Losses on capital assets held two years or less, other than stocks and bonds, were allowed in full against any kind of income. Losses on assets held over two years were treated as they had been since 1924. Stock purchased in "wash sales" was included in the capital gains provision, and losses from their sale restricted to 12½%. The wash sales provisions were revised to prevent fictitious losses on stock sold and repurchased the

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1. Ratner, S., op. cit. p. 427

same day.[1/] The method of treatment of net gains of individuals for assets held two years or less remained the same as in the 1921 act. The treatment of net gains on assets held over two years, and net losses held over two years remained the same as in 1924. The first change in the basic treatment of capital losses of corporations since the year 1913 was made. Losses from sale or exchange, by a corporation, of stocks and bonds which were held two years or less were limited to the gains from such sales. A loss incurred in one year, not in excess of net income, could be carried over and applied against gains from the sale or exchange of stocks and bonds held two years or less in the following year. Other capital losses were treated as they had formerly been, allowing them in full against losses of any kind. Treatment of corporate capital gains from the sale or exchange of assets remained unchanged, the gains being included with other income subject to full rate.

The first New Deal Congress in 1933 made few revisions to the income tax as a whole, although changes were made in the treatment of capital losses. For both the individual and the corporation losses from the sale or exchange of stocks and bonds held two years or less were limited to the gains from such sales, the carry-over provision on such transactions being eliminated. Other capital losses were al-

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1. Ratner, S., p.449

lowed in full against income of any kind. The basic treatment of other portions of capital gains and losses remained unchanged. The act also imposed an excess profits tax and a companion capital stock tax.

The revenue act of 1934 increased the tax rates and was designed to prevent tax avoidance. Losses on sales or exchanges between members of the same family were disallowed. The method of dealing with capital gains and losses of individuals was changed completely by applying graduated percentages to the gain or loss from the sale of capital assets, in accordance with the length of time the asset had been held. The percentage rates on the period assets were held are as follows:

One year or less..........................100%
Over one year but not over two years......80%
Over two years but not over five years....60%
Over five years but not over ten years....40%
Over ten years............................30%

Capital gains thus recognized were included in net income and were subject to regular tax rates. Losses from sales or exchanges of capital assets of individuals could be deducted to the extent of the capital gain, plus two thousand dollars of ordinary income. No losses could be carried forward to later years.

Corporation losses from sale or exchange of assets

were allowed up to the amount of any capital gains plus two thousand dollars of ordinary income. Corporate gains continued to be treated in the same manner as they had been treated since 1913, being included with other income subject to the full tax rate, and receiving no special treatment for the length of time the capital assets were held.

The revenue act of 1935, sponsored by President Roosevelt in his message to Congress on June 19, 1935, increased the rates of surtax, but made little change in the provisions for capital gains and losses. Tax free exchanges of receipts of property by a corporation in liquidation of another corporation were defined.[1]

The revenue act of 1936 made no basic changes in the treatment of capital gains and losses. An undistributed profits tax was, however, adopted. One of the several reasons offered for this tax was the evasion of taxes by some taxpayers by allowing surpluses to accumulate in controlled corporations. An attempt to prevent taxpayers from evading income taxes by incorporating was not a novel idea. Every income tax law that had been adopted had contained some such provision. These provisions were difficult to enforce, however, as it was necessary to prove that the corporation was formed for the purpose of evading the tax and this was practically impossible to do.[2]

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2. Ibid., op. cit. p. 404.

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The revenue act of 1937 attempted to close some of the loopholes in the tax law by increasing the tax on personal holding companies, and by broadening the definition of a personal holding company. Certain losses from sales or exchanges were disallowed: Losses between members of a family; losses between an individual and a corporation of which the individual owned more than 50% of the stock; losses between two corporations which were owned by the same individual who had more than 50% of the value of the stock of the two corporations; losses between a grantor and a fiduciary of a trust; losses between the fiduciaries of any two trusts if the same person was grantor of both trusts; losses between the fiduciary of a trust and a beneficiary of the trust.[1/]

The revenue act of 1938 made many changes in the income tax law, including several important changes in the treatment of capital gains and losses. Poor business conditions in 1937 caused the charge from high taxpayers that the tax policy of the government was the cause of the depression. As a result of their pressure the tax on capital gains was reduced for persons in the higher tax brackets.[2/] There were previously several different rates of tax depen-

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1. Blakey, R. and G., op. cit. p. 434.

2. Strayer, Paul J., The Taxation of Small Incomes, Social, Revenue, and Administrative Aspects, The Ronald Press Company, New York, 1939.

ding on the length of time of the holding period. It was claimed that this resulted in influencing holding or sales of securities to take advantage of the law.[1] Capital gains and losses for taxpayers other than corporations were, under the 1938 act, separated into long term and short term transactions. Short term assets were those held eighteen months or less, while long term assets were those held more than eighteen months. Net short term capital gains were taxable in full at ordinary rates. Short term capital losses were allowed up to the amount of short term capital gains. Where the short term capital losses were greater than the short term capital gains in any one year, the net short term capital loss could be carried forward for one year to an amount not in excess of the net income for the year from which it was carried over and applied against gains from short term capital transactions in the following taxable year.[2]

Long term transactions for taxpayers other than corporations were divided into two classifications: Assets held more than eighteen months but not more than twenty-four months; assets held more than twenty-four months. The percentage of gain or loss taken into account from the sale or exchange of the former was sixty-six and two thirds; the per-

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1. Ratner, S., op. cit., p. 480.
2. Section 117(e), Revenue Act of 1938.

centage of gain or loss taken into account from the sale or exchange of the l tter was fifty percent.[1] The net gain so computed was taxable at the prevailing normal and surtax rates. The individual taxpayer could elect to compute his net long term capital gains (at the above percentages) separately from other types of income and have them taxed at thirty percent of this amount in lieu of the normal tax and surtax, thus setting a ceiling on taxes from this type of transaction.[2] The thirty percent provision was of advantage to persons with incomes of over twenty-six thousand dollars. Net capital losses were computed on the percentages given above. The net long term capital loss thus computed was deducted from other income without limitation by the amount of long term capital gains; or before deducting the net loss, thirty percent of the loss could be credited against the tax computed on net income before subtracting the loss. The taxpayer was obligated to utilize whichever of the above computations gave the greater tax.[3] Net long term capital losses could not be carried over as could net short term capital losses.

The basic method of treatment of capital gains and losses of corporations did not change. Gains from sale or

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The law excluded from the definition of capital assets depreciable property used in the taxpayer's trade or business. This allowed taxpayers to take losses from the sale or abandonment in full, instead of at diminished rates.

In determining the period for which property was held which was received in an exchange, the time that the old property was held was included. The new property had the same basis as the exchanged property.[2]

If a taxpayer held property whose basis for the purpose of determining gain or loss was determined by the basis in the hands of another person then the time the asset was held included the holding period of that other person.[3]

Worthless stock, bonds, and notes of corporations were included in the definition of capital assets, and they could no longer be subject to the full deduction.[4]

The period for which stock or securities were held which were received upon a distribution where no

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1. Revenue Act of 1938, Section 117 (d) (1).
2. Ibid., Section 117 (h) (1).
3. Ibid, Section 117 (h) (2).
4. Ibid, Section 23(g), (k)

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3. Ibid, Section 117 (h) (2).
4. Ibid, Section 23(g), (2)

gain was recognized to the distributee under the provisions of section 112(g) of the revenue act of 1938 (no gain recognized if additional stock received on reorganization and holding not surrendered), or under section 371(c) of the revenue act of 1938 (no gain from receipt of stock or securities distributed in obedience to an order of the Securities and Exchange Commission to a shareholder in a registered holding corporation or a majority owned subsidiary corporation) included the period during which the taxpayer held stock or securities in the distributing corporation before the distribution.[1]

Banks or trust companies incorporated under the laws of the United States, states, territories, or the District of Columbia, a substantial part of whose business was the receipt of deposits, who sold any receipt of corporation or governmental indebtedness with interest coupons or in registered form at a loss, were not subject to the ordinary corporate limitation of "two thousand dollars plus the gains from such sales or exchanges", except the portion of the loss by which the adjusted basis of the instrument exceeds the par value.[2]

Upon retirement of certificates of indebtedness of a corporation, government, or governmental subdivision

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1. Revenue Act of 1938, Section 117(h) (3).

2. Ibid., Section 117(d) (1).

with interest coupons or in registered form, the amounts received are considered as amounts received in exchange for the purpose of determining capital gains and losses.[1] Without this provision such transactions would not be within the meaning of "sale or exchange" and hence not includible under the provisions for capital gains and losses.

Sections 118(a), (b), and (c) were adopted to limit "wash sale" losses ... "where it appears that within a period beginning thirty days before the date of such sale or disposition and ending thirty days after such date the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire substantially identical stock or securities". Under Section 118(a) no deduction for the wash sale loss is allowed except for "a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business". Sections (b) and (c) state that in a wash sale, where the amount of securities acquired or covered by contract or option to acquire is less than the amount disposed of or more than the amount disposed of, then the particular shares from which the loss is not deductible were to be determined by the rules and regulations of the Commissioner with the approval of the Sec-

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1. Revenue Act of 1938, Section 117(f).

retary.

The period for which stock or securities were held which were acquired in a wash sale in which the loss was not deductible included the period during which the older stock was held.[1]

On the partnership return it became required that capital gains and losses be separated from other income and calculated as though for an individual taxpayer. Each partner was required, in his own return, to include his share of the partnership ordinary net income and short term gains or losses, and was required to combine both his personal long term gains and his share of the partnership long term gains or losses.

The basis of property acquired by gift after December 31, 1920, was the same as the basis in the hands of the donor except "for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower."

In 1939 the Internal Revenue Code was adopted. With regard to capital gains and losses, in a speech

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1. Revenue Act of 1938, Section 117(h) (4)

before the Committee on Ways and Means in May, 1939, Secretary of the Treasury, Henry Morgenthau, stated that the limitation restricting deductions of corporate capital losses to two thousand dollars in excess of capital gains was inequitable. When the law was finally passed, long term capital losses (of assets held more than eighteen months) of corporations were deductible and were allowed in full against any kind of income. Short term (eighteen months or less) capital losses were deductible only to the extent of short term capital gains.[1] Short term capital losses disallowed in one year, to an amount not in excess of net income were permitted to be carried over and applied to short term capital gains in the following year.

The basic treatment of capital gains and losses for taxpayers other than corporations remained unchanged from its form in 1938.

In determining the length of time stock or stock rights were held which were received in a distribution where the basis was determined by Section 13(a)(19)(A) (applies to stock or stock rights acquired before January 1, 1936; or on or after that date if the distribution did not constitute income within the meaning of the Sixteenth

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1. Revenue Act of 1939, Section 212 (a), Amended Code Section 117 (d).

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The basic treatment of capital gains and losses for taxpayers other than corporations remained unchanged from its form in 1938.

In determining the length of time stock or stock rights were held which were received in a distribution where the basis was determined by Section 113(a)(19)(A) (applies to stock or stock rights acquired before January 1, 1936; or on or after that date if the distribution did not constitute income within the meaning of the Sixteenth

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1. Revenue Act of 1939, Section 212 (a), Amended Code Section 117 (d).

Amendment) the holding period could include the period the old stock was held prior to receiving the new stock or rights. This was subject to the regulations of the Commissioner and approval of the Secretary.[1]

The revenue act of 1940 did little to change the basic methods for computation of capital gains and losses. The second revenue act of 1940 is best known for reviving the excess profits tax, which was requested by President Roosevelt in a special message to Congress on July 1, 1940. The name of the old excess profits tax was changed to "declared value excess profits tax."

The revenue act of 1941 stated that "an obligation of the United States or any of its possessions, or of a state or territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue"... was not included in the definition of a capital asset.[2]

The revenue act of 1942 again changed the method of computation of capital gains and losses to the basic form

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1. Revenue Act of 1939, Section 214 (c), Added to Code Section 117 (h).

2. I. R. C. Section 117 (a) (1).

which is used at the date of this writing. The following changes were made for taxpayers other than corporations. Capital gains and losses were divided into long term (capital asset held more than six months), and short term (capital asset held for not more than six months). Short term gains and losses were recognized in full (100%) while long term transactions were recognized only to the extent of 50%. Both the long term and short term capital transactions are combined after applying the above mentioned percentages. If there is a net capital loss it may be taken up to the amount of $1,000 or ordinary income, whichever is smaller. The remainder of the net capital loss, if any, can be carried over for five succeeding years, and applied against capital gains plus $1,000 or other net income, whichever is smaller. Net capital gains are ordinarily taxed at the same rates as ordinary income, although relief may be granted by the alternative tax.

An alternative method of taxing capital gains and losses was allowed to taxpayers whose net long term capital gains exceeded net short term capital losses, which in effect put a tax ceiling of twenty-five percent on this excess. "If for any taxable year the net long term capital gain of any taxpayer (other than a corporation) exceeds the net short term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax

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is less by the tax imposed by such sections: A partial tax shall first be computed on the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection has not been enacted, and the total tax shall be the partial tax plus 50 per centum of such excess."[1] Unlike the alternative provisions of prior years there was no alternative for a net loss.

With regard to corporations, the definition of long term and short term gains and losses was the same as for taxpayers other than corporations: in order to have a long term capital gain or loss the capital asset must have been held for more than six months; for a short term capital gain or loss, six months or less. However, unlike taxpayers other than corporations, both long and short term transactions were accountable in full. The long and short term transactions were then combined into a "net capital gain or loss". A net capital loss could not be deducted in any amount in the year sustained, but could be carried over for five years and applied against net capital gains of those years. In the case of a net capital gain, this was taxable at the usual corporate rates for ordinary income. Relief was afforded by allowing an alternative tax of twenty-five percent of the excess of net long term

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1. I. R. C. 117 (c) (2).

is less by the tax imposed by such sections: A partial tax shall first be computed on the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection has not been enacted, and the total tax shall be the partial tax plus 30 per centum of such excess."[1] Unlike the alternative provisions of prior years there was no alternative for a net loss.

With regard to corporations, the definition of long term and short term gains and losses was the same as for taxpayers other than corporations; in order to have a long term capital gain or loss the capital asset must have been held for more than six months; for a short term capital gain or loss, six months or less. However, unlike taxpayers other than corporations, both long and short term transactions were accountable in full. The long and short term transactions were then combined into a "net capital gain or loss". A net capital loss could not be deducted in any amount in the year sustained, but could be carried over for five years and applied against net capital gains of those years. In the case of a net capital gain, this was taxable at the usual corporate rates for ordinary income. Relief was afforded by allowing an alternative tax of twenty-five percent of the excess of net long term

1. I. R. C. 117 (c) (2).

capital gains over net short term capital loss, thus setting a tax ceiling of twenty-five percent on this type of transaction.

Depreciable property used in trade or business, and real property used in trade or business, held by the taxpayer for more than six months, and which is not properly includible in the inventory of the taxpayer or property held primarily for sale to customers in the ordinary course of trade are considered "property used in the trade or business" for this subsection. If the recognized gains on the sale or exchange of property used in the trade or business, plus the recognized gains from compulsory or involuntary conversion of property used in trade or business and capital assets held for more than six months exceed the recognized losses from these sales, exchanges or conversions, then these gains and losses were considered as sales or exchanges of capital assets held for more than six months. If the losses exceed the gains, however, then the gains and losses were not considered as gains and losses from the sale or exchange of capital assets.[1] The effect of the above provisions was to allow deductible losses from this type of transaction, while at the same time granting this type of transaction favorable tax rates in the case of gains,

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Depreciable property used in trade or business, and real property used in trade or business, held by the taxpayer for more than six months, and which is not properly includible in the inventory of the taxpayer or property held primarily for sale to customers in the ordinary course of trade are considered "property used in the trade or business" for this subsection. If the recognized gains on the sale or exchange of property used in the trade or business, plus the recognized gains from compulsory or involuntary conversion of property used in trade or business and capital assets held for more than six months exceed the recognized losses from these sales, exchanges or conversions, then these gains and losses were considered as sales or exchanges of capital assets held for more than six months. If the losses exceed the gains, however, then the gains and losses were not considered as gains and losses from the sale or exchange of capital assets.[1] The effect of the above provisions was to allow deductible losses from this type of transaction, while at the same time granting this type of transaction favorable tax rates in the case of gains.

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1. Revenue Act of 1942, Section 151 (b), Added to Code Section 117 (j).

by considering them as capital assets.

Involuntary conversion was considered the same as an exchange. For tax purposes the time the new asset was held includes the time the involuntary asset was held. Similarly, the basis of the new asset is the same as the basis of the old.[1]

The length of time stock or securities were held which were acquired by the exercise of rights to acquire these stocks or securities, includes only the period beginning with the exercising of the rights.[2]

In the case of banks, if the losses exceeded the gains from the sale or exchange of registered or coupon bonds, debentures, notes, or certificates, or other evidence of indebtedness issued by a corporation, government, or governmental subdivision, then no such sale or exchange is considered a capital asset.[3] The effect of this provision was to allow banks to take losses from such transactions for tax purposes, while maintaining the ceiling of twenty-five percent of net long term capital gains.

The treatment of capital gains and losses remained substantially the same in 1943. Special provisions were incorporated into the law for gain or loss on

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1. Revenue Act of 1942, Section 151 (c) (1).

2. Ibid., Section 101, Added to Code Section 117 (h).

3. Ibid., Section 150 (d), Added to Code Section 117 (i).

the cutting of timber. Section 127(c) of the revenue act of 1943 amended code section 117(j) to include in the definition of "property used in trade or business ... timber with respect to which subsection (k) (1) or (2) is applicable." In accordance with the revenue act of 1942 "property used in trade or business" receives special favored treatment. Section 117(k) added to the Code by section 127(a) of the revenue act of 1943 is as follows:

(k) Gain or Loss Upon the Cutting of Timber.-

(1) If the taxpayer so elects upon his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or who has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than six months prior to the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. In case such election has been made, gain or loss shall be recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this paragraph such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract to cut and shall be binding upon the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Commissioner, on showing of undue hardship, permits the taxpayer to revoke his election; such revokation, however, shall preclude any further elections under this paragraph except with the consent of the Commissioner.

(2) In the case of the disposal of timber (held for more than six months prior to such disposal) by the owner thereof under any form or type of contract by virtue

of which the owner retains an economic interest in such timber, the difference between the amount received for such timber and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber.

The Acts of 1944 and 1945 including the Individual Income Tax Act of 1944, the Tax Adjustment Act of 1945, and the Revenue Act of 1945 did little to change the provisions for capital gains and losses, although many other changes were incorporated into the laws.

CHAPTER III

TREATMENT OF CAPITAL GAINS AND LOSSES FOR THE TAXABLE YEAR 1946

Capital gains and losses are distinguished by the Internal Revenue Code from other types of income and losses. The law does not [illegible] with the [illegible] of [illegible] but [illegible] as well to the [illegible] of [illegible] of the [illegible], trusts and corporations. Various limitations on such [illegible] are taken into account in computing net income [illegible]. Generally, to make these limitations apply the following conditions must exist:

(1) The property must be a "capital asset".

(2) The method of disposition must be a sale or exchange.

Capital Assets, as Defined

As defined by law[1] the term "capital assets" means "property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable

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1. I. R. C., Section 117 (a) (1).

Chapter III

COMPUTATION OF CAPITAL GAINS AND LOSSES FOR THE TAXABLE YEAR 1946

Capital gains and losses are distinguished by the Internal Revenue Code from other types of gains and losses. The law does not require that the gains on certain capital asset transactions be applied in full in the computation of net income of the taxpayer other than the corporation. Various limitations on such losses taken into account in computing net income apply to all taxpayers. Generally, to make these limitations apply the following conditions must exist:

(1) The property must be "a capital asset".

(2) The method of disposition must be a sale or exchange.

Capital Assets, Definition of

As defined by law[1/] the term "capital assets" means "property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable

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1. I. R. C., Section 117 (a) (1).

year; or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; or property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1); or an obligation of the United States or any of its possessions, or of a state or territory, or any political subdivision thereof, or the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from date of issue, or real property used in the trade or business of the taxpayer."

Sale or Exchange, Definition of

As stated above, the method of disposition of the asset, in order to make Section 117 of the Internal Revenue Code applicable must be a sale or exchange. In Hale v. Helvering, (1936)[1] the court quoted the following definitions:

"A sale is a contract whereby one acquires a property in the thing sold and the other parts with it for a valuable consideration."[2]

"An exchange is: A mutual grant of equal interests, the one in consideration of the other."[3]

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1. 66 App. D. C. 245, 85 F. (2d) 819, 18 AFTR 520.
2. Words and Phrases, Second Series, Volume 4, p. 437.
3. Webster's New International Dictionary, 1931.

"The distinction between a sale and exchange of property is one of shadow rather than one of substance. In both cases the title to property is absolutely transferred; and the same rules of law are applicable to the transaction, whether the consideration for the contract is money or by the way of barter. It can make no essential difference in the rights and obligations of the parties that goods and merchandise are transferred and paid for by other goods and merchandise instead of by money which is but the representative of value of property."1/

Expressly included by law in the definition of a "sale or exchange" are certain situations which are not ordinarily classified as such. Section 23(g)(2) and Section 23(k)(2) of the Internal Revenue Code deals with worthless securities and Section 23(k)(4) deals with non-business bad debts.

In many cases where the question arose as to whether or not a particular type of transaction was a "sale or exchange" the courts have made decisions. These decisions are the law. Where there is any doubt as to whether a particular transaction is a sale or exchange, it is advisable to study those decisions to find a similar case as a basis for your actions.

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1. 14 Gray 367 (Massachusetts Reports)

Application of Limitations

The application of limitations on capital gains and losses depends upon the time the asset was held, the type of taxpayer, how the property was acquired, and whether the transaction resulted in a gain or loss.[1]

Short Term and Long Term

Capital gains and losses are of two general types, depending upon how long the asset was held: short term and long term. A short term gain or loss is one in which the asset was not held more than six months,[2] while a long term gain or loss is one in which the asset was held more than six months.[3] A difference of one day in the date of sale can be a determining factor in whether or not a particular transaction resulted in a long term or a short term gain or loss. To compute the period held, exclude the date on which the property was acquired but include the date of the date of disposal of the property.

The differentiation between short term and long term is important, as in the case of taxpayers other than corporations only fifty percent of the long term gain or

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1. I.R.C. Section 117.
2. Ibid., Section 117 (a) (2)-(3).
3. Ibid., Section 117 (a) (4)-(5).

loss is taken into account in computing the tax. In the case of a corporation with a long term gain or loss, or in the case of any taxpayer (including the corporation) with a short term gain or loss, the amount taken into account is one-hundred percent.[1] Examples follow:

Jones, a taxpayer, sold for $12,000 bonds which he had purchased five years previously (longer than six months ... long term) at a cost of $10,000. His actual gain is $2,000, but since this transaction results in a long term capital gain, only fifty percent of this amount represents his long term capital gain. His long term capital gain is $1,000.

Sales price	$12,000
Cost	10,000
Actual Gain	2,000
Long term capital gain 50% of actual gain	1,000

Long term capital loss is computed in a similar fashion. Let us assume in the above problem that the selling price was $7,000.

Cost	$10,000
Selling Price	7,000
Actual Loss	3,000
Long term capital loss 50% of actual loss	1,500

1. I. R. C. Section 117 (b)

Short term capital gains and losses (property held six months or less) for taxpayers other than corporations are taken into account 100% in computation of capital gain or loss. In the above two problems if the holding periods had been six months or less, then the short term <u>capital</u> gain or loss would be in the same amount as the <u>actual</u> gain or loss as computed.

With regard to corporations, all gains or losses, both short term and long term, are taken into account 100% in the computation of capital gain or loss. The transactions should be separated into long and short term gains and losses, however, as the "alternative" tax may afford relief.

Under the regular method of computation, all gains and losses, both short term and long term, are combined after the percentages have been applied. In the case of the taxpayer other than the corporation the capital net loss is deductible to the extent of $1,000 or other net income of the taxpayer, whichever is less. The disallowed loss may be carried over for a period of five years following the year in which the loss was incurred. In each succeeding year the taxpayer other than the corporation may offset his net capital gains with his carried over loss,

plus his other net income or $1,000 whichever is smaller.[1] Examples follow:

Examples of Net Gain or Loss from Capital Transactions

After applying the percentages, J. Doe had a net short term capital gain (excess of short term capital gains over short term capital losses for year)[2] of $5,000 and a net long term capital loss (excess of long term capital loss over long term capital gains for year)[3] of $1,000. His net gain from the sale or exchange of capital assets was $4,000. (5,000 less 1,000)

After applying the percentages J. Doe had a net short term capital loss (excess of short term capital losses over short term capital gains for year)[4] of $8,000, and a net long term capital gain (excess of long term capital gains over long term capital losses for year)[5] of $2,000. His net loss from the sale or exchange of capital assets was $6,000. (8,000 less 2,000)

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1. I. R. C. Section 117 (a) (10) (B); 117 (e) (1); Regulation 29. 117-2 (c).

2. I. R. C. Section 117 (a) (6).

3. Ibid., Section 117 (a) (9)

4. Ibid., Section 117 (a) (7)

5. Ibid., Section 117 (a) (8)

Example of Net Gain in Return

Where there is a net gain it is simply added to other income to obtain net income.

Other income................................	$5,000
Net gain from capital transactions......	1,000
Net income..................................	6,000

Net Loss in Return, Limitation of

"In the case of a taxpayer other than corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges, plus the net income of the taxpayer of (or) $1,000, whichever is smaller. For purposes of this paragraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets."[1] Examples illustrating the law follows:

1.	Other income..................................	$5,000
	Net loss from capital transactions $2,500	
	Deduction limited to $1,000 per year.......	1,000
	Net income....................................	4,000
	Balance carried over to succeeding year....	1,500

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1. I. R. C. Section 117 (d) (2).

2.	Other income....................................	$ 600
	Net loss from capital transactions $2,500	
	Deduction limited to "other income" because it is less than $1,000....................	600
	Net income....................................	None
	Balance carried over to succeeding years ($2500 less $600)........................	1,900

Capital Loss Carry Over

"If....the taxpayer has a net capital loss, the amount thereof shall be a short term capital loss in each of the five succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. For purposes of this paragraph a net capital gain should be computed without regard to such net capital loss or to any net capital losses arising in such intervening taxable years."1/ "The amount of the net capital loss carry-over may not be included in computing a new net capital loss of a taxable year which can be carried forward to the next five succeeding taxable years."2/

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1. I. R. C. Section 117 (e)(1)

2. Regulations 111, Section 29.117-2

The corporation may not deduct a net capital loss against its other income.[1] The net loss can be carried forward over a period of five years, however, and in each succeeding year it may be offset against the net capital gain in such year.

Example of Carry-Over of Net Loss for Corporations

The X Corporation has a net capital loss of $5,000 for the year 1946. No part of this may be deducted from other income. In 1947 the corporation had a net capital gain[2] of $2,000. This $2,000 is offset against the net capital loss carry-over from 1946, leaving a balance of $3,000 to be carried forward to 1948. ($5,000 less $2,000 equals $3,000). In 1948 a net capital loss of $500 was incurred, none of which can be deducted from ordinary income but which amount can be added to the carry-over for the following year ($3,000 plus $500 equals $3,500). In 1949 the corporation had a net capital gain of $5,000 against which the carry-over of $3,500 is offset, leaving a balance of $1,500 to be added to other income for computation of the tax in the ordinary way, or may be taxed under the alternative tax, at the corporation's option. (5,000 less $3,500 equals $1,500).

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1. I. R. C. Section 117 (d) (1); Regulations 29.1.7-2.

2. The definition of a net capital gain for a corporation in accordance with I. R. C. Section 117(a) (10)(A) is "the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges."

Example of Capital Loss Carry-Over,

Regulations 111, Section 29.117-2

	1942	1943	1944	1945	1946
Carry-over from prior years					
From 1942		($50,000)	($29,500)	($29,500)	
From 1944				($19,500)	($13,000)
Net short term loss (computed without regard to the carry-overs)	($30,000)	($5,000)	($10,000)		
Net short term gain (computed without regard to the carry-overs)				40,000	
Net long term loss	(20,500)		(10,000)	(5,000)	
Net long term gain		25,000			
*Net capital gain (computed without regard to the carry-overs		20,500		36,000	
Net income (computed without regard to the carry-overs	500	500	500	1,000	
Net capital loss	(50,000)	None	(19,500)	None	

*The definition of a net capital gain of a taxpayer other than a corporation in accordance with Section 117(a) (10)(B) is "(i) the sum of the gains from sales or exchanges of capital assets, plus net income of the taxpayer or $1,000 whichever is smaller, over (ii) the losses from such sales or exchanges. For purposes of this paragraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets."

The Alternative Tax

The alternative method[1] of computation of tax for individuals or corporations for net long term gain has the effect of putting a ceiling on the amount of taxes paid on this class of income of twenty-five percent of the net long term capital gain in excess of the net short term capital loss. The alternative method is used only when the amount of the tax payable is less than it would be under the ordinary method allowed to the taxpayer.

Computation of Alternative Tax for Taxpayers Other than Corporations[2]

1. Compute the net income in the ordinary manner (including capital computations at the ordinary percentages).

2. Deduct the excess of net long term capital gains over net short term capital loss from the net income computed in Step 1. Compute the tax in the usual manner on the remainder of the income. This figure is known as the "partial" tax.

3. Add to the partial tax fifty percent of the excess of net long term capital gain over net short term capital loss.

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1. I. R. C. Section 117 (c) (2); I. R. C. (c) (1).

2. Ibid., Section 117 (c) (2).

Example of Computation of Alternative Tax for Taxpayers

Other than Corporations

The taxpayer, single, and with no dependents has a salary of $30,000, net long term capital gains of $15,000, and net short term capital losses of $5,000 for the year 1946. Under the regular method his tax would be computed as follows:

Net income ($30,000 plus 15,000 minus 5,000)...	$40,000
Less...exemption for taxpayer..................	500
Surtax net income................................	39,500
Tentative surtax on $39,500.....................	18,210
Less 5% of $18,210...............................	910.50
Surtax..	17,299.50
Net income..	40,000
Less...exemption for taxpayer..................	500
Balance subject to normal tax..................	39,500
Tentative normal tax(3% of 39,500).............	1,185
Less 5% of 1,185.................................	59.25
Normal tax..	1,125.75
Total tax liability (normal tax plus surtax)...	$18,425.25

Under the alternative method the tax would be computed as follows:

Ordinary net income ($40,000 plus $5,000 less $15,000		$30,000
Less...Exemption for taxpayer		500
Surtax net income		29,500
Tentative surtax on $29,500		12,025
Less 5% of $12,025		601.25
Surtax		11,423.75
Ordinary net income		30,000
Less...Exemption for taxpayer		500
Balance subject to normal tax		29,500
Tentative normal tax, 3% of $29,500		885
Less 5% of $885		44.25
Normal tax		840.75
Partial tax (surtax plus normal tax)		12,264.50
Add: 50% of the excess of net long term capital gain over net short term capital loss		
Net long term capital gain	$15,000	
Less...net short term capital loss	5,000	
Excess of N.L.T.C.G. over N.S.T.C.L.	10,000	
50% of excess of N.L.T.C.G. over N.S.T.C.L.		5,000
Total tax		$17,264.50

In comparing the alternative method with the regular method it is seen that the alternative method, in this problem, produces the smaller tax. Consequently this is the method utilized. If the alternative tax had produced a higher tax, however, then the regular method would have been employed.

Computation of Alternative Tax for Corporations[1]

1. Compute the net income in the ordinary manner (including capital computations).

2. Deduct the excess of net long term capital gains over net short term capital losses from the net income computed in Step 1. Compute the tax in the usual manner on the remainder. This figure is known as the "partial tax".

3. Add to the partial tax 25% of the excess of net long term capital gains over net short term capital losses.

It may be observed that in Step 3 of the computation of the alternative tax for corporations twenty-five percent of the excess of net long term capital gain over the net short term capital loss is added to the partial tax, while in the same step for the computation of the tax for a taxpayer other than a corporation the amount to

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1. I. R. C. Section 117 (c) (1).

be added is fifty percent of the excess of net long term capital gain over the net short term capital loss. The reason for this that the object of the alternative tax is to limit the tax to not more than twenty-five percent of this excess. In computing the net long term capital gain for the corporation the "actual" gains were computed in full; but when computing the net long term capital gain for the taxpayer other than the corporation only fifty percent of the "actual" gain was counted. The alternative rates of twenty-five percent and fifty percent, respectively, tend to equalize but not equal the tax for all taxpayers on these transactions. That the tax is not equal may be demonstrated by the following figures.

Example:

Two taxpayers, one a corporation, and the other a taxpayer other than a corporation, both have actual long term capital gains of $5,000 and actual short term capital losses of $1,000. The alternative tax is computed as follows.

Corporation:

Net long term capital gain
(same as actual long term gain)....................$5,000

Less...Net short term capital loss....................1,000

Excess of N.L.T.C.G. over N.S.T.C.L..................4,000

Alternative rate of 25% ($4,000 x 25%)

Alternative tax for corporation.....................$1,000

Taxpayer other than a corporation:

Net long term capital gain (50% of actual gain...$5,000 x 50%)..............	$2,500
Less...Net short term capital loss..................	1,000
Excess of N. L. T. G. over N. S. T. C. L............	1,500
Alternative rate of 50% ($1,500 x 50%)	
Alternative tax for taxpayer other than a corporation...........................	$ 750

Determination of Amount of Gain or Loss

Determination of the amount of gain or loss is governed by I. R. C. Section 111. "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."[1] The "amount realized" includes not only money, but the fair market value of any other property received.[2] It is to be noted that if the gain or loss is a capital gain or loss, the recognized gain or loss is taken into account only up to the amounts of the percentages which were described earlier in this chapter.

Sales for cash. The amount of gain or loss is equal to the difference between the adjusted basis and the cash received.

Sales where notes are received. The amount of gain or loss is equal to the difference between the

1. I. R. C. Section 111 (a)

2. Ibid., Sec 111 (b)

adjusted basis of the asset disposed of and the fair market value of the notes received. If the property sold is realty or a casual sale of personal property which would not be properly included as inventory, then under certain conditions the income received may be reported on the installment basis, over a period of several years. The conditions are:[1]

1. A sale of real property
2. A sale of above described personal property for a price exceeding $1,000.
3. Initial payments do not exceed 30% of selling price. Notes or other evidences of indebtedness are not included in the term "initial payments".

Property for property. Under certain conditions the exchange may be tax-free, as will be described later in this chapter. If taxable, however, the amount of gain or loss is equal to the difference between the adjusted basis and the fair market value of property received.

Declaration of dividends in property or stock of another corporation may result in a taxable gain or loss depending on the wording of the dividend resolution. It was held that a company could distribute without taxable gain

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1. I. R. C. Section 44 (b)

the stock of another corporation on which there was an actual gain, providing the wording of the declaration of dividends expressed the intent that the dividend would be made in this stock.[1] But in another case where a dividend was declared, not specifically stating that it was to be distributed in the form of Liberty Bonds, and these bonds, on which there was a gain, were distributed then a taxable gain resulted to the corporation.[2]

The same general principles apply in the case of a dividend distribution in stock or in property on which there is a loss. Where a dividend of a specific dollar amount was declared, and payment made with bonds of a reduced market value, plus a given amount of cash, and the value of the bonds were computed at the reduced market value, then the corporation incurred a deductible loss.[3] In another case bonds purchased at par whose market value had declined were paid out at par value in fulfilment of a dividend obligation amounting to the par value, then no deductible loss was received by the corporation.[4]

<u>Gains or losses on sales of tax exempt securities</u> result in taxable gains and deductible losses.[5] An exception, by law, are treasury bills issued after June 17, 1930 but prior to March 1, 1941. Neither gains nor losses are recognized from their sale or other disposition.[6]

1. Gen. Ut. and Op. Co., 27 BTA 1200, 29 BTA 934, rev. (CCA-4), 74 F (2d) 972, 15 AFTR 108, 296 US 200, 80 L. Ed 154, 56 S.Ct. 185, 16 AFTR 1126, Ct. D. 1055, CB June 1936, p. 214

2., 3., 4., 5., 6., on page 49C

Sale of stock rights may give rise to taxable gain or loss. The following rules are applied where stock rights are sold. The basis of the stock is apportioned to both the stock and the rights in proportion to the actual value of the stock and rights at the time the rights are issued. The amount of the original basis thus allocated to the rights, divided by the number of rights will be the amount of the basis of each new right. Similarly, the amount of the original basis allocated to the stock, divided by the number of shares of stock, will be the amount of the basis of each share of stock. The following expresses the above statements in mathematical formulae:[1/]

Continued from page 48 B

2. Bacon-McMillan Veneer Co., 20 B. T. A. 556

3. Callanan Road Improvement Co., 12 B. T. A. 1109

4. Parkersburg Iron & Steel Co., 17 B. T. A. 74, (C. C. A.-4), 48F (2d) 163, A. F. T. R. 1078, Ct. D. 360 CB 1940-1, p. 6

5. Willatts v. Bunn, 282 U. S. 216, 75 L. Ed. 304, 71 A. L. R. 1260, 51 S. Ct. 125, 9 A. F. T. R. 584, Ct. D. 280, C. B., June 1931, p. 309.

6. Public No. 376, Seventy-first Congress, H. R. 12440

Footnote pg. 48 C

1. Derived from Reg. 111, Sec. 29.22 (a)-8 (As amended by T. D. 5458, June 15, 1945), paragraph (1)

$\left(\frac{MS}{MS+MR}\right)$ BS=New basis of total shares of stock

$\left(\frac{MR}{MS+MR}\right)$ BS=Basis of total number of stock rights

$\frac{\text{New Basis of total shares stock}}{\text{Number of shares of stock}}$ =New basis per share stock

$\frac{\text{Basis of total number stock rights}}{\text{Number of stock rights}}$ =Basis per stock right

MS Total market value of old stock (when rights issued)

MR Total market value of stock rights (when rights issued)

BS Basis of old stock.

SS Subscription price of additional shares acquired through exercising stock rights.

Where the shareholder exercises his rights to subscribe for new stock the basis for his stock is computed as follows (using symbols employed in previous paragraph):[1]

Basis of old stock computed in identical manner as preceding paragraph.

$\left(\frac{MR}{MS+MM}\right)$ BS + SS = Basis of total number new shares acquired

$\frac{\text{Basis of total number of new shares}}{\text{Number of new shares}}$ = Basis per new share stock

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1. Derived from Reg. 111, Sec. 29.22 (a)-8 (As amended by T. D. 5458, June 15, 1945), paragraph (2)

<u>Sale of patents and copyrights.</u> Amount of gain or loss is equal to difference between basis of patent or copyright, including an adjustment for depreciation, and its selling price. If the patent or copyright is purchased, its basis is the price paid. If acquired from the government the expenses incurred such as lawyers fees, government fees, drawings and models are included in the basis. If the inventor acquires his patent or copyright from the government he cannot include in his basis the value of his time, only the actual expenses being considered.[1]

<u>Sale of good will.</u> There is a gain or loss from a sale of good will only when the business, or the portion of the business to which the good will is attached is sold.[2] Good will is connected with the going value of the concern, and cannot be sold independently of the going value of the concern.[3] "If specific payment was not made for good will, there can be no deductible loss with respect thereto, but gain may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or other basis...".[4]

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1. O. D. 966, C. B. December 1921, p. 155

2. Reg. 111, Sec. 29.22 (a)-10

3. Dodge Bros., Inc., v U. S. (CCA-4; 1941), 118 F. (2d) 95, 26 AFTR 620, affirming 33 F. Supp. 312, 25 AFTR 220.

4. Reg. 111, Sec. 29.22 (a)-10, op. cit.

This statement is qualified by the fact that if there was good will in existence on March 1, 1913, although it was not purchased, then it can be considered in determining the taxable gain or loss from the disposal of the business.[1]

Recognition of Gain or Loss

In accordance with the general rule promulgated in I. R. C. Section 112 the entire amount of gain or loss is recognized upon the sale or exchange of property. There are many exceptions, however, to this general rule.

Gain from the sale of property is recognized in all cases with the exception of the special case of "Gain from sale or exchange to effectuate policies of Federal Communications Commission".[2]

Nontaxable Exchanges

There is no gain or loss where common stock is exchanged for common stock in the same corporation or preferred stock is exchanged for preferred stock in the same corporation.[3] An exchange of bonds for bonds of the same corporation was not held to be within the above concept,[4] and such a transaction would result in gains or losses.[5]

Where property held "for productive use in trade or business or for investment" is exchanged for property of a like kind, and it is to be employed for productive use in trade or business or for investment, then no gain

1. Schilling Grain Co., 8 BTA 1048
2. I. R. C. Section 112 (m)
3. I. R. C. Section 112 (b) (2)
4. W. H. Field, 41 B. T. A. 183
5. I. T. 2035, CB June 1924, p.55

or loss is recognized. "Stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest "are not included in the definition of "productive use in trade or business or investment". Examples of the allowable items are the exchange of a truck for a truck; or apartment property for vacant lots;[1] and real estate for other real estate.[2]

If in all the previously mentioned nontaxable exchanges there is received in addition to property which is allowed to be received, other property or money, then the following rules apply:[3]

1. Gain is recognized "in an amount not in excess of the sum of money and the fair market value of the other property."
2. Loss is not recognized.

If property is transferred to a corporation in exchange for the stock or securities of that corporation, then no gain or loss is recognized. Where two or more persons effect the above exchange, the above provisions will not apply unless the "amount of stock and securities

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1. Harr v. McLaughlin, 15 F. Supp 1004, AFTR 354

2. Biscayne Trust Co., Ex. (Est. of Phillip Ullendorf) 18 BTA 1015

3. Reg. 111, 29.112 (c)-1

or loss is recognized. "Property held for productive use in trade or business, has shares, stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest" are not included in the definition of "productive use in trade or business or investment". Examples of [illegible] similarly [illegible] are the exchange of a truck for a truck, or apartment property for vacant lots; and real estate for other real estate.[2]

If in all the previously mentioned nontaxable exchanges there is received in addition to property which is allowed to be received, other property or money, then the following rules apply:[3]

1. Gain is recognized "in an amount not in excess of the sum of money and the fair market value of the other property."
2. Loss is not recognized.

If property is transferred to a controlled corporation in exchange for the stock or securities of that corporation, then no gain or loss is recognized. Where two or more persons effect the above exchange, the above provisions will not apply unless the amount of stock and securities

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1. [illegible], p. [illegible] page 356
2. [illegible] 1012
3. Reg. 111, 29.112 (c)-1

received by each is substantially in proportion to his interest in the property prior to the exchange."[1] The term "control" as used above is defined as the possession of "at least eighty percent of the total combined voting power of all classes of stock entitled to vote and at least eighty percent of the total number of shares of all other classes of stock of such corporation."[2]

Involuntary conversions are defined as:

"property, (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith and in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund."[3]

If there is an involuntary conversion and the above specifications are complied with, then:[4]

1. No gain is recognized.

2. Loss is recognized.

3. If any money received as a result of the involuntary conversion is not expended for the replacement, and there is a gain, then the gain is recognized up to an amount not in excess of the unspent money

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1. I. R. C. Section 112 (b) (5)
2. Reg. 111, Sec. 29-112(b)(5)-1
3. I. R. C. Section 112 (f)
4. Ibid; Regulations 111, Sec. 29.112(f)-1

No gain or loss is recognized in certain reorganization exchanges. The term"reorganization" is given specific definitions under I. R. C. Section 112 (g)(1). No gain or loss is recognized in certain insolvency reorganization exchanges pursuant to court order or approval. A detailed explanation of the substance of these reorganizations will not be made here.

It should be noted at this point that tax-free exchanges do not cancel all future tax liabilities on the property received. At a later date this property may be disposed of in a manner which will cause a taxable gain.

Basis for Gain or Loss

The computation of the basis for gain or loss is governed by I. R. C. Section 113. Paragraph (a) states that "the basis of property shall be the cost of such property", but there are many exceptions to this rule depending on how the taxpayer acquired the property.

To determine the basis of property, the unadjusted basis is first determined, and necessary adjustments are made. Gain or loss is the difference between the amount realized and the adjusted basis.

For the remainder of this chapter the term "basis", unless otherwise specifically stated will mean unadjusted basis.

To compute the adjusted basis, the basis must be adjusted for any expenditures, receipts, or other items which are properly charged to the property. An adjustment is obviously necessary, for example, when there is an addition attached to an existing building.

Property acquired before March 1, 1913. If the adjusted basis on March 1, 1913 is less than the fair market value of this date, then the basis for determining gain is the fair market value.[1] If the adjusted basis is greater than the fair market value as of March 1, 1913 then the adjusted basis is used for the purpose of determining gain.[2] If there is a loss from the sale of property acquired before March 1, 1913, the above alternatives are not allowed and the basis adjusted from the date of acquisition must be used.[3]

The basis of property acquired by bequest, devise or inheritance is the fair market value at the date of death of the decedent. If the decedent died after October 21, 1942 and the executor used the optional valuation dates for the purposes of the estate tax, then the valuation date chosen for this purpose will be the date that governs

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1. I. R. C. Section 113 (a) (14)

2. Tracy v. Commissioner, 53 F (2d) 575, 10 AFTR 683, cert denied.

3. Ibid.

fot the income tax. The optional valuation dates are the value at the date one year after the death of the decedent, or the date of distribution if within one year after the decedent's death.1/

The basis of a gift or transfer in trust prior to January 1, 1921 is the fair market value at the time of gift or transfer in trust.2/ The basis of a gift after December 31, 1920 depends on whether there is a gain or loss. If there is a gain"the basis is the same as it would be in the hands of the donor, or the last preceding owner by whom it was not acquired by gift." If there is a loss, the same method as used for determining gain basis, or the fair market value of the property at the date of the gift, whichever id lower, is used to determine the basis.3/ Under this method of computing the basis, if there is a loss, and the fair market value of the property is less than the basis of the donor, then if the selling price lies between the fair market value and the donor's basis, there is neither gain nor loss. The basis of a gift by transfer in trust is computed in the same manner as that of an ordinary gift.4/

The basis of property acquired in a <u>non-taxable exchange</u> is subject to the following rules.5/

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1. Reg. 111, Sec. 29.113 (a) (5)-1
2. Reg. 111, Sec. 29.113 (a) (4)-1
3. Reg. 111, Sec. 29.113 (a) (2)-1
4. 1942 amendment of I. R. C. Section 113 (a) (3)
5. Reg. 111, Sec. 29.113 (a) (6)-1 (as amended by TD 5402, 9/ 5/ 44

If none of the gain or loss was recognized in the exchange, then the basis of the new property is the same as the adjusted basis of the old property at the date of the exchange.

Where money is received in an exchange the basis of the new property received is the basis of the old property adjusted to the date of the exchange, less the total amount of money received. If there is a gain on the exchange then the previously computed amount is increased by the amount of the gain to obtain the new basis. If there is a loss on the exchange then the aforementioned computed amount is decreased in the amount of the loss to obtain the new basis.

Where in an exchange there is money given in addition to property transferred, then the basis of the new property is the adjusted basis of the old property at the date of the exchange, plus the amount of money given.

If property not permitted to be received without the recognition of gain, and money were received, then the basis for the total property received, excluding the money, is computed as follows. The basis of the old property adjusted to the date of the exchange is decreased by the money received, and to this amount is added the amount of gain which was recognized. The basis of the property not permitted to be received is its fair market value. The basis of the property received without recognition of gain

If none of the gain or loss was recognized in the exchange, then the basis of the new property is the same as the adjusted basis of the old property at the date of the exchange.

Where money is received in an exchange the basis of the new property received is the basis of the old property adjusted to the date of the exchange, less the total amount of money involved. If there is a gain on the exchange then the previously computed amount is increased by the amount of the gain to obtain the new basis. If there is a loss on the exchange then the aforementioned computed amount is decreased in the amount of the loss to obtain the new basis.

Where in an exchange there is money given in addition to property transferred, then the basis of the new property is the adjusted basis of the old property at the date of the exchange, plus the amount of money given.

If property not permitted to be received without the recognition of gain, and money were received, then the basis for the total property received, excluding the money, is computed as follows. The basis of the old property adjusted to the date of the exchange is decreased by the money received, and to this amount is added the amount of gain which was recognized. The basis of the property not permitted to be received is its fair market value. The basis of the property received without recognition of gain

is the basis of the total property, minus the fair market value of the property not permitted to be received without recognition of gain.

Where in a tax-free exchange the party other than the taxpayer assumes certain liabilities of the taxpayer, then the amount of these liabilities is treated as money received by the taxpayer for the purpose of computing the basis of the property received.[1] Exceptions to the above rule are corporation reorganizations for the purpose of reducing tax liability,[2] reorganization of corporations under the Bankruptcy Act, before September 22, 1938,[3] and the non-taxable liquidation of a subsidiary by the parent corporation.[4]

The basis of property involuntarily converted[5] is the same as the basis of the old property if all of the money received was expended and no loss recognized.

If a gain occurs from the involuntary conversion, and not all of the money received is expended on replacements, then the new basis is the basis of the old asset adjusted to the date of the involuntary conversion, less any money not expended, plus the recognized gain.

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1. Reg.111, Sec. 29.113 (a) (6)-2, IRC Sec. 113 (a) (6)

2. Gregory v Helvering, 293 U. S. 465, 55 St. Ct 266, 79 L. Ed 596, 14 AFTR 1191

3. I. R. C. Sec. 113 (b) (4)

4. Reg. 111, Sec. 29.112 (b) (6)-1

5. I. R. C. Sec. 113 (a) (9); Reg. 111, 29.113 (a) (9)-1

Where in replaving the involuntarily converted asset the cost is greater than the amount received then the basis of the new asset is equal to the basis of the old asset adjusted to the date of the involuntary conversion, plus the excess of money expended ofer the amount of money received.

Certain charges such as some kinds of taxes,[1] interest,[2] and others, if they have not been deducted, may be used to increse the basis of property.[3]

Determination of Period Capital Assets Held

It is obvious that time is of the essence in determining whether a capital transaction is short term or long term. Since there are large tax differentials it is important to become familiar with the methods to determine whether or not an asset was held six months for tax purposes.

The general rule in the case of property purchased for cash is that the time held excludes the day on which the property was acquired, and includes the date

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1. Regs. 111, 29.24-5, GCM 17920, 1937-1 CB 68, others
2. I. T. 2664, XI-2 CB 43; SM 5033, V-1 CB 9
3. I. R. C. 24 (a) (7)

of disposition.[1/]

Property transmitted at death acquired directly from decedent's estate is a problem not definitely answered in Section 117 but has been decided before the United States Supreme Court.[2/] The date of death governs.

Property acquired by remainderman from testamentary trust...Period held has been decided by the Supreme Court to be from the date of death of the original decedent.

Nontaxable exchanges...Period held determined by date of acquisition of asset given in exchange.[3/]

Property acquired in exchange for property involuntarily converted has the same date basis as the property converted.[4/]

Gifts or transfers in trust...Date basis of transfers in trust after December 31, 1920 is the date of acquisition by grantor.[5/] Gift after December 31, 1920, in case of a gain...Date basis is same as that of donor. In case of a loss, if at the date of gift the fair market value of property is less than basis to donor, donee's

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1. Harriet M. Hooper, 26 BTA 758 (petition for review dismissed by CCA-2, 1/30/33); IT 3287, C.B. 1939-1, p. 138.

2. McFeeley et al v. Commissioner, 296 US 102, 80 L. Ed 83, 56 S. Ct. 54, 16 A.F.T.R. 965, Ct D. 1040, C.B. Dec. 1935, p. 209, rehearing denied, 296 U.S. 664, 80 L. Ed. 473, 56 S Ct. 304-306, 16 A.F.T.R. 1284.

3. I. R. C. Section 117 (h) (1).

4. Ibid.

5. Minnie M. Fay Trust "A", 42 B.T.A. 765.

holding period begins with the date of gift.[1/]

Stock received in reorganization. Under certain tax-free reorganizations the time held begins with the acquisition of the old shares.[2/] Under certain other types of reorganization, however, there is a taxable exchange and the new securities date from the actual date of acquisition.[3/]

Purchase of securities in a wash sale. Losses from wash sales are disallowed. The disallowed wash sales are defined in I. R. C. Section 118 (a) as "any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities where it appears that, within a period beginning thirty days before the date of such sale or disposition and ending thirty days after such date, the taxpayer has acquired, (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option to acquire such securities." The time that the new stock is held includes the actual time that the above old stock (which was disposed of) was held. For the purpose of wash sales, if the total number of days the

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1. I. T. 3453, CB 1941-1, p. 254

2. I. R. C. Section 117 (h) (3)

3. Ibid., Section 117 (h) (3); S. H. Berch, 35 B. T. A. 385 (petition for review dismissed by Court of Appeals, D. C., Dec. 9, 1938).

stock is held is one-hundred-and-eighty-three or less, there is a short term transaction; if one-hundred-and-eighty-four days or more, a long term transaction. For example, assume the following transactions:

	Date	Purchased		Date	Sold		Time Held
Lot A*	1/15/46	1000 sh. @	100	3/1/46	1000 sh. @	85	45 days
Lot B*	2/20/46	"	90	4/20/46	"	85	59 days
Lot C*	5/16/46	"	80	8/2/46	"	75	78 days
					TOTAL		182 days

*Substantially identical stock purchased by an individual for investment purposes.

The above stock was held for a total of one-hundred-and eighty-two days, and since this is less than one-hundred and eighty-four days, is a short term capital loss.[1]

It should be noted that the days held include only the days that each lot of stock was actually held. If there were an overlapping period of five days where two lots of substantially identical stock were held, then the total days held is 2 x 5. If at any period in the transaction no shares of stock are held, then this period is not counted in the

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1. Letter dated February 25, 1948, and signed E. I. McLarney, Deputy Commissioner. Modifies Bureau ruling of April 17, 1947. Example taken directly from letter.

time the stock is held. This differs from the method of computation used in prior years where "the holding period commences with the date of acquisition of the original securities and ends with the date of sale of the repurchased securities ... although for a period of time the taxpayer held no substantially identical securities and for another period of time he held two lots of such securities.[1]

The period which stock dividends and rights are held date from the time the old stock was acquired if these stock dividends and rights were non-taxable when received (i.e. common on common); or if taxable were received before January 1, 1936 and are not included in I. R. C. Section 113 (a) (19) (b), (c) or (d). Paragraph (b) states that where stock rights were sold before 1939 and the entire amount was included in gross income then the basis of the old stock is in no way affected by the rights. Under paragraph (c), where stock dividends or rights were received before 1936 and these were included as dividends in the gross income, then the basis of the old stock is not affected. Paragraph (d) refers to special cases where the stock dividends or rights

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1. Letter dated February 25, 1948, and signed E. I. McLarney, Deputy Commissioner. op. cit.

or the old stock was disposed of prior to 1936 and a special basis for determining gain or loss was granted by the "courts or the Board of Tax Appeals, or a closing agreement, and the decision or agreement became final before the nineteenth day after the date of enactment of the Revenue Act of 1939" Where stock dividends and rights are taxable and received after December 31, 1935 the period held dates from the actual time of acquisition of these dividends or rights.

The holding period of stock obtained by the use of stock rights dates from day upon which stock rights exercised.

The first-in, first-out rule concerns sales of stocks which were purchased at different dates or at different prices. Unless the identity of the individual shares bought at these different dates and prices can be determined, then the stock must be charged against the earliest purchase.

Special Rules

Certain special rules regarding capital gains and losses are of importance.

Worthless stocks[3] and bonds[4] are subject to limitations on capital losses although no sale or exchange has taken place and are considered a loss from the sale or exchange on the last day of the taxable year in which they became worthless.

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1. I. R. C. Section 117 (h) (6)
2. Regulation 29.22(a)-8
3. I. R. C. Section 23 (g)
4. Ibid., Section 23 (k)

Losses on hedging...Futures transactions representing true hedges against fluctuations in the spot price of goods are considered insurance costs rather than capital amounts subject to limitations.[1/]

Amounts received on retirement of bonds, debentures, notes or other certificate of indebtedness of a corporation or government are considered as amounts received in exchange [2/]

Under I. R. C. Section 117 (j) the following are subject to relief provisions:

Property used in trade or business which is subject to allowance for depreciation and real property used in business and held for more than six months.

Cutting of timber, under certain conditions and at the taxpayer's election.

If the recognized gains of the above named items mentioned in Section 117 (j) exceed the losses, then these gains and losses are considered as long term capital gains and losses, and since the alternative tax applies, the maximum tax upon the gains would be twenty-five percent. If the losses exceed the gains, however, the excess loss is deducted as an ordinary loss. For a more complete discussion of this matter see the revenue

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1. G. C. M. 17322, C. B. December, 1936, p. 151.

2. I. R. C. Section 117 (f).

acts of 1942 and 1943, Chapter II, this text.

Losses incurred by a bank in the sale or exchange of bonds, debentures, notes, certificates or any other evidence of indebtedness of a corporation or government, which exceed such gains in a taxable year, are not considered sales or exchanges of capital assets.[1]

Joint Returns

Capital losses of one spouse may be set off against the capital gains of the other.[2] For example, the husband has a long term recognized gain of $4,000 (therefore a long term capital gain of $2,000). He has no capital losses. His wife has a short term capital loss of $5,000. She has no capital gains. Her loss is deductible on the current joint return to the extent of $3,000 (long term capital gain of $2,000 plus $1,000 of ordinary net income).

Installment Sales

The capital gains provisions do not affect the method of accounting. The recognized gain is computed in the ordinary required manner. The amount of capital

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1. I. R. C. Section 117 (i).

2. Helvering v. Janney, Gaines v. Helvering, 311 U.S. 189.

gain is computed from the recognized gain in the usual manner. The holding period for the gain or loss from the disposition of installment obligations is determined by the holding period of the property sold, and not the length of time the installment obligations were held.[1]

Information on Particular Problems

To determine the status of a particular transaction the taxpayer can turn to the Internal Revenue Code; Treasury Regulations (which are the Treasury Department's interpretation of the Internal Revenue Code): the Administrative Rulings of the Treasury Department and the Bureau of Internal Revenue; Court decisions; or any of the tax services which coordinate and consolidate the above material in a convenient manner for use.

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1. I. R. C. 44(d); Regs. 111, Sec. 29.44-5; Rogers v. Commissioner (CCA-2), 143 Fed. (2d) 695, Cert. denied, 323 U.S. 780.

CHAPTER IX

BRITISH PRACTICES IN TAXATION OF CAPITAL GAINS AND LOSSES

The attitude of the British towards the taxation of capital gains is reflected in the writings of Lord Stamp, Principles of Taxation, 1936. "The British mode of view in the income sphere between the United States and ourselves, shows itself in the attitude towards the inclusion of capital gains as income. It is perhaps natural in a country that is continually rising to capital values, and continually realizing them, and where capital operations in real property and in stocks are an everyday occurrence touching 'ability to live', that such gains shall be equally subjected to 'ability to pay'. But the underlying presumption is one of continuous movement, and in this country we have considered the game to be hardly worth the candle, for, the progress of the country being more stable, in the long run losses would have to offset gains. In any case, the losses would have to come in the fall, and the result be great discrepancy! It is important in our view that if gains are charged losses must be allowed too, and this was the characteristic of the early American provision."

The present income tax law in Great Britain is divided into five "schedules". Each of these

Chapter IV

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The present income tax law in Great Britain is divided into five "schedules". Each of these divi-

sions defines the type of income which must be reported within it. Nowhere is there a general definition of income for income tax purposes. If any class of income does not fall within the definitions of a section, then it is not within the scope of the income tax.[1/]

The words of the schedules which impose the charge are as follows:[2/]

Schedule A. Tax under schedule A shall be charged in respect of the property in all lands, tenements, hereditaments, and heritages in the United Kingdom, for every twenty shillings of the annual value thereof.

Schedule B. Tax under schedule B shall be charged in respect of the occupation of all lands, tenements, hereditaments, and heritages in the United Kingdom for every twenty shillings of the assessable value thereof estimated in accordance with the rules of this schedule.

Schedule C. Tax under schedule C shall be charged in respect of all profits arising from interest, annuities, dividends, and shares of annuities payable out of any public revenue, for every twenty shillings of the annual amount thereof.

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1. Report of the Royal Commission on the Income Tax, London, H. M. Stationery Office (1920).

2. Magill, R., Taxable Income, Revised Edition, The Ronald Press Company, New York, 1945, p. 71.

Schedule D. Tax under this schedule shall be charged in respect of--

(a) The annual profits or gains arising or accruing--

(i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere; and

(ii) to any person residing in the United Kingdom from any trade, profession, employment, or vocation, whether the same be carried on in the United Kingdom or elsewhere; and

(iii) to any person whether a British subject or not, although not resident in the United Kingdom, from any properties in the United Kingdom, or from any trade, profession, employment, or vocation exercised within the United Kingdom; and

(b) All interest of money, annuities, and other annual profits or gains not charged under schedule A, B, C, or E, and not specially exempted from tax;

in each case for every twenty shillings of the annual amount of the profits or gains.

Schedule E. Tax under schedule E shall be charged in respect of every public office or employment for profit, and in respect of every annuity, pension, or stipend payable by the Crown or out of the public revenue of the United Kingdom, other than annuities charged under schedule C, for every twenty shillings of the annual amount thereof.

Schedule D is charged under six cases which are as follows:[1]

Case I. Profits of trade, manufactures, adventures, or concerns in the nature of trade.

Case II. Income from professions and vocations.

Case III. Interest paid in full and assessable directly upon the recipient, including interest on certain British Government securities as explained under schedule C.

Case IV. Income from Dominion and foreign securities (except that from government securities chargeable under schedule C.).

Case V. Income on Dominion and foreign possessions.

Case VI. Profits from sources not falling under

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1. Taxation of Incomes, Corporations and Inheritances in Canada, Great Britain, France, Italy, Belgium, and Spain, Senate Document No. 186, p. 32.

any of the foregoing cases or under any other schedule.

Schedule D is the only one of the five schedules that is pertinent to the subject of capital gains and losses, with case I and case VI being of interest.

The British interpretation of cases I and VI of schedule D of their income tax act is brought out by the court decisions. The decisions bring out the point that "Casual, non-recurring or occasional profits arising from transactions that do not form part of the ordinary business of the person who makes them are accordingly held not to be within the scope of the income tax and consequently escape taxation."[1] The above statement might be somewhat qualified, however, on the basis of the cases to follow.

Jones v. Leeming[2] is the leading British case on the subject. The taxpayer was charged with case I and case VI, Section D. of the income tax act. The pertinent facts of the case are that the taxpayer (and others) had purchased two options to buy rubber plantations, apparently with the hope of reselling these options at a profit. The options were sold at a profit. Lord Buckmaster's reasoning

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1. Report of the Royal Commission on the Income Tax, London, 1920.

2. 1930 A. C. 415.

indicates the result of this type, and similar types of transactions for tax purposes;[1] "Can the profits made in this case be described as income? Were the respondent a company promoter or were his business associated with the purchase and sale of estates, wholly different considerations would apply, but this negatived; the transaction in this case stands isolated and alone. It is to my mind in the circumstances purely an affair of capital. I can see no difference between it and what might have happened had the respondent bought shares in two companies which were going to be amalgamated, and then sold equivalent shares in the amalgamated company at a profit; an accretion to capital does not become income merely because the original capital was invested in the hope and expectation that it would rise in value; if it does so rise, its realization does not make it income."

The above case is different, in the eyes of the British Courts, than Rutledge v. the Commissioners,[2] where the taxpayer, not in the course of his usual line of business, purchased a million rolls of toilet tissue and sold them at a large profit. Lord Sands in his decision stated:

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1. Magill, R., op. cit., p. 74.

2. (1929) S.C. 379, 14 Tax cas. 490; Magill, R., op. cit. p. 75.

The nature and quantity of the subject dealt with exclude the suggestion that it could have been disposed of otherwise than as a trade transaction. Neither the purchaser nor any purchaser from him was likely to require such a quantity for private use."

The question of what constitutes a "trade" is answered in Pickford v. Quirke,[1] which also indicated some of the discretionary powers allowed the tax commissioners; and Martin v. Lowry.[2] A brief background of the cases may aid in a better understanding of the decisions.[3]

For a period of years during and after the First World War there were many large profits from isolated trading ventures, and since these were non-taxable, there was much dissatisfaction expressed especially since the government needed the revenue at that time. The Commissioners attempted to tax certain of these profits, and the subsequent litigation defined the law more clearly, and broadened the powers of the Commissioners.

At this time there were many mills undergoing reorganizations with porfits to the large stockholders who negotiated the transactions. It was not attempted to

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1. 1937, 138, L.T. 500.

2. 1927, A.C. 312.

3. May, G. O., British Treatment of Capital Gains, Journal of Accountancy, June, 1942

assess the profits of taxpayers who had made a single transaction of this kind, but persons who had made several such transactions were assessed. At a meeting of the Board of Commissioners assessments against three taxpayers who had made several of these transactions were upheld. One of the taxpayers appealed the decision, resulting in the case of Pickford v. Quirke, in which the decision of the Board of Commissioners was upheld. Lord Hanworth, the Master of the Rolls, stated:[1]

"Now you may have an isolated transaction so independent and separate that it does not give you any indication of carrying on a trade. It must be remembered that under the interpretation clause trade 'includes every trade, manufacture, adventure or concern in the nature of a trade.' When, however, you come to look at four successive transactions you may hold that what was, considered separately and apart a transaction to which the words 'trade or concern in the nature of a trade' could not be applied, yet when you had that transaction repeated, not once, nor twice, but three times, at least, you may draw a completely different inference from those incidents taken together. That is what the Commissioners have done ... they go on: 'The question as we have stated it, is we think a question of degree,' and they deal with

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1. Magill, R., op. cit., p. 76.

the matter further. I think they are right. If it is a question of degree it is a question of fact, and, in my judgment the Commissioners were quite right in applying, or in reconsidering, the facts known to them beforehand in the previous case which they had decided but the true measure of which they had not taken from the point of view of whether a particular individual was carrying on a trade or an adventure in the nature of trade when those several matters are threaded up together and considered from a general point of view."

Martin v. Lowry,[1] the other case in point, is somewhat spectacular because of the amounts of money involved. The taxpayer purchased a quantity of surplus airplane linen and sold it in a period of eight months at a profit of over one-and-one-half-million pounds. The Special Commissioners ruled that this constituted carrying on a trade, and this decision was upheld by the courts. Commenting upon the decision of the court in this case, Raymond Needham, a leader of the English Tax Bar stated:

"The argument adopted on behalf of Mr. Martin rested on the view that the expression 'annual profits' means profits recurring year by year or derived from a

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1. 1927 A.C. 312; Magill, R., op. cit., p. 79.

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1. 1927 A.C. 312; Magill, M., op. cit., p. 79.

source capable of, or intended to be capable of producing profits year by year. This view has, however, been unanimously rejected by the Court of Appeals."

Two further cases elaborate on different phases of the same problem: McKinley v. Jenkins and Sons, Ltd.[1/] and Cooper v. Stubbs.[2/]

In the case of McKinley v. Jenkins a profit was made on the purchase and sale of Italian lira. The transactions in foreign exchange occurred because of a business contract which was made to purchase Italian marble. The Commissioner and the Courts held that the transaction in foreign exchange was not part of the business contract, and was an isolated purchase not entered into as a trade, hence not taxable.[3/]

In Cooper v. Stubbs[4/] a cotton broker made profits by trading in futures of cotton. It was his contention that these were not profits connected with a trade, but were gambling profits. The Court of Appeals decided against the taxpayer, finding him taxable under both case I and case VI, Section D. It was decided that the

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1. 10 Tax Cas 372.
2. 1925, 10 Tax Cas 29.
3. Magill, R., op. cit., p. 88.
4. Ibid., p. 75.

dealings were sufficiently recurrent and annual, and that the profits were not accretions to capital as there was no investment in property, but rather an intention to make profits through differences in prices.

In the case of transactions made by corporations it is sometimes possible to determine from the charter that these transactions are a part of the ordinary business of the taxpayer, and hence taxable.

In the case of California Copper Syndicate v. Harris,[1/] the charter of the corporation empowered it, among other things, to acquire and sell its properties. The company sold part of its properties at a profit. The court decided that this was a taxable transaction, Lord Justice-Clerk (Sir J. H. A. MacDonald) stating:

"It is quite a well settled principle ... that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D ... But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable where ... an act (is) done in what is truly the carrying on or carrying out of a business....

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1. Magill, R., p.81.

"The question ... (is), is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit making?

"...this company was in its inception a company endeavoring to make profit by a trade or business ... It is manifest that it never did intend to work this mineral field with the capital at its disposal. Such a thing was quite impossible. Its purpose was to exploit the field and to obtain gain by inducing others to take it up on such terms as would bring substantial gain to themselves. This was that the turning of investment to account was not to be merely incidental, but was, as the Lord President put it in the case of the Scottish Investment Company (31 Scot L.R. 219, 3 Tax Cas 231), the essential feature of the business speculation being among the appointed means of the Company's gains."

In another leading case, The Hudson's Bay Company, Ltd. v. Stevens,[1] it was decided that the sale of lands was not taxable. The Hudson's Bay Company had sold certain land which had been granted to it by the government. It was decided that land owning was not a

1. 25 T.L.R. 709, 5 Tax Cas. 424, 428 (C.A., 1909); Magill, R., op. cit., p. 85.

trade. It was stated by the Master of the Rolls (Cozens Hardy):

"The Company are doing no more than an ordinary landowner does who is minded to sell from time to time, as purchasers offer, portions suitable for building of an estate which has devolved upon him from his ancestors."

The case that might, perhaps, be of most interest to an American reader is strangely missing. The technical staff of the Joint Congressional Committee on Taxation, in its report to that Committee estimated that eighty-five percent of capital gains in the United States were the results of transactions in securities. Roswell Magill, in his Taxable Income, Revised, 1945, states, "No cases involving sales of securities by individuals have been found, indicating apparently that the taxpayer and the inspector are able to agree that such sales are clearly in the course of business, or are clearly not."

The differences between the terminology as used in the United States and Great Britain might best be explained in the words of our own Justice Holmes, in construing the word "income". "A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used."1/

1. Towne v. Eisner, 245 U.S. 418, 38 Sup. Ct. 158 (1918).

Advantages and Disadvantages of the British Practice

From the standpoint of the British, capital gains and losses are not important enough from a revenue producing standpoint to be taxed. It is their belief that in a static economy such as theirs, the losses would offset the gains.[1]

Preparation of the income tax return is simplified by the elimination of the computations necessary to determine gain or loss. "It should also be noted that with the exception of capital gains comes as a corollary the absence of any deduction for depletion, obsolescence, or 'wastage' of capital, though wear and tear allowances are granted, and amounts not so recovered tax-free are deductible if the asset is actually replaced."[2]

Elimination of taxes on capital transactions free the securities and other capital markets from the ill effects of the tax. There is no incentive to sell when the market is low and take losses for tax purposes. On the other hand there is no high tax to discourage the taxpayer from realizing his gains. This tends to give

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1. Lord Stamp, Principles of Taxation, 1936.

2. Vickrey, W., Agenda for Progressive Taxation, The Ronald Press Company, New York, 1947, p. 137.

more stability to the market.

However, capital gains, casual, non-recurring, or occasional profits that do not form part of the income of the person who makes them, if they are not truly income, at least represent taxpaying ability. There seems to be little justice in the practice of allowing persons with high capital gains to escape the tax entirely, while their fellows who perhaps earn considerably less through their labor, and are less able to pay the tax, are subject to full taxation.

That the British themselves are not completely satisfied with the present provisions of the law is evidenced by the Report of the Royal Commission of 1920, dealing with casual profits, one paragraph of which is here quoted:

"Several witnesses have called our attention to the possibility and the desirability of increasing the revenue by widening the doors of the tax so as to admit profits which at present are not regarded as assessable income. They are satisfied that the narrow scope of the existing charge cannot be justified, and should be enlarged. We feel very strongly that at a time like the present when taxation is necessarily high, to allow whole classes of sometimes highly profitable transactions to lie outside the range of the Income Tax, on the narrow

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technical ground that the resulting profits are not of a recurring character, should no longer be permitted, and we have been made aware that the existence of this exemption is felt to be a real grievance by other tax-payers whose profits are taxed to full. The difficulty will be to open the doors wide enough to bring in what is desired to include and yet not so wide as to admit what should be left outside, but we consider that an attempt should be made to overcome this difficulty in view of the importance and desirability of the object sought to be achieved."

Chapter V

ECONOMIC EFFECTS OF CAPITAL GAINS AND LOSSES PROVISIONS

Are Capital Gains Income?

There is a vast difference of opinion among economists and others as to the definition of the word "income".[1] Most definitions of income fall under one of three classifications.

1. Income is a recurrent flow of goods and services which is measured in monetary values or prices.

2. Income is consumer satisfaction, measured in the monetary value of flow of services enjoyed by an individual.

3. Income is economic power, measured in monetary value of the net accretion without deduction for personal expenses.

The first of the above definitions limits income to recurrent items such as wages, interest, or business profits, but does not include as income gifts, legacies or capital gains.[2] Great Britain, with certain exceptions, follows this rule and does not include capital

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1. Wueller, Paul H., "Concepts of Taxable Income", Political Science Quarterly, Vol. LIII, 1938, p. 83-110 and 557-583.

2. Plehn, C., "Recurrent Consumable Receipts", American Economic Review, Vol. XIV, 1924, p. 1-12.

gains and losses as income.

Under the concept of consumer satisfaction income is not what a man receives but what he spends, plus "psychic" income (services from one's own home, automobile, etc. and one's own labor for personal comfort and welfare).1/

Under the third definition of income, that of net accretion without deduction for personal expenses, are included all accretions to income such as salaries and wages, business profits, interest, rents, royalties, dividends, bequests, gifts, psychic income, and capital gains and losses.2/

The Federal income tax has followed, with certain exceptions, the latter definition of income. The several exceptions will not be elaborated upon except to note that capital gains and losses are given special treatment. Since the Revenue Act of 1921 gain or loss from the sale of capital assets has been distinguished for the purposes of income tax from ordinary income. The Supreme Court has qualified the recognition of gains and losses by stating that they must be "realized" before they become income.3/

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1. Fischer, Irving, "Income in Theory and Income Taxation in Practice", Econometrica, Vol. V, January, 1937, pp. 47-48.

2. Haig, R. M. The Federal Income Tax, Columbia University Press, 1921, p. 27.

3. 252 U.S. (1920), 89, Eisner v. Macomber.

Before World War II the various countries which employed the income tax arrived at different answers to the question of whether or not to include capital gains and losses as income. Great Britain and France, for example, did not include these transactions as income; while Germany and Italy followed the practice of the United States. As regards the practices in the various states in the Union, capital gains are subject to the income tax in all states having general income tax laws except Iowa, Maryland, and South Dakota.

Should Capital Gains be Taxed?

The question has been raised several times as to whether or not capital gains should be taxed. It is argued that capital gains are cancelled by capital losses, and hence should not be utilized for tax purposes. In opposition it is argued that capital gains exceed capital losses[1] and (the obvious fact) that the gains and losses are often received by different individuals.

It is said by some that capital gains are not income and do not represent any gain in the national wealth. Capital gains may be due to a rise in the value

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1. Hearings, Revenue Revision, 1934, p. 45, U. S. 73'd Congress, 2'd session, 1933-34, House of Representatives, Committee on Ways and Means.

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1. Heeringa, Revenue Revision, 1934, p. 45, U. S. 73'd Congress, 2'd session, 1933-34, House of Representatives, Committee on Ways and Means.

of money. If this is the case, then the gain may be an illusory gain and represents no increase in purchasing power.

There is the oft repeated tale of the man who bought a house for $10,000 and during an inflationary period the value of the house doubled. For some reason the man had to move to another town. He sold the house at the current value of $20,000 and bought another, exactly like it in the new city, paying $20,000. Without special tax provisions this man would be taxed on a profit of $10,000 although he had actually gained nothing. Another point of view, with similar reasoning is that capital gains represent the present value of expected future income and that it is unfair to tax both the anticipation and the realization of this income.[1]

But a rise in the value of money affects all types of income. Capital types of assets are not singled out. If a man receives a higher wage during an inflationary period this does not increase his ability to pay a graduated tax if the cost of living has risen in the same proportion to his wages. As regards the problem of the unfortunate man with his houses, he can probably rent the first house and wait until the boom is over before

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1. Plehn, C. C., Introduction to Public Finance, (5th edition), Longmans, Green Co., New York, 1934, p. 272.

selling it. If he wants to sell it, he has a profit of $10,000 which, if it cannot be classified as income, is at least money. There is no reason why the government should disregard the receipt of this money in the hope that he will purchase another house for an absurd price at the top of a boom.[1]

Some consider that if depreciation is allowed as an expense then capital gains should be included as income. "If it lessens his taxes, no business man objects to the deduction of depreciation from gross income ... But when it comes to appreciation his own ox is gored; so a different theory of income must be evolved. He argues that capital gain is something different than income and hence should not be taxed ... He stresses and magnifies the difficulties into reasons for abolishing the tax, even if he has to hire economists, accountants, and lawyers to assist him in the job."[2]

Some persons advocate taxing capital gains in order to at least partially plug loopholes in the law.

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1. T. S. Adams, Capital and the Federal Income Tax: Address before the U. S. Chamber of Commerce, May 1, 1931.

2. Fagan and Macy, Public Finance, Longmans, Green and Company, New York, 1934, p. 436.

If a corporation reinvests its earnings instead of declaring dividends, then the value of the stock usually rises. If the stockholder then sold his shares, he would realize a capital gain. It has not been unknown for persons to incorporate for the purpose of converting large ordinary incomes into capital gains, in order to obtain favorable tax rates. Under the British system these gains would not be taxable in spite of the fact that they are in a sense "earned" and are of the same material as dividends, salaries, and other ordinary income, which are taxed in full. Under a system which taxes capital gains, these increases in value of securities would be taxed at least in part. The Internal Revenue Code, Section 102 was designed to prevent avoidance of individual income taxes through accumulation of corporate surpluses. But without the capital gains provisions there would be many methods of avoiding the above section.

In any event it is sometimes not clear where to draw the line between ordinary business income and capital transactions. Many capital gains are received by corporations and other businesses and these capital gains seem more closely related to ordinary business gains. Another instance is the case of the individual who spends a great deal of his time attending to his

investments and receives capital gains. Such cases are the argument for including capital gains in ordinary income.

Should Capital Gains Be Treated Specially?

Under the present income tax laws, capital gains and losses are given special treatment, having a ceiling which treats gains rather favorably and a loss limitation which perhaps works a hardship on some taxpayers. These provisions have come about because of the characteristics of capital transactions which make them different from most ordinary transactions.

There is sometimes an apparent injustice upon the person who retains his capital assets for several years, while they gradually appreciate in value. When the assets are sold, the rate may be higher than what he would have paid had the tax been computed on the annual increment in value. A tale is told[1] of "an individual who purchases a farm which he operates for many years with little or no profit, remaining content because of the belief that the annual increase in the value of his land will eventually provide a fair return for his labor and investment. But finally

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1. Groves, H. M. Financing Government, Henry Holt and Company, New York, 1939, p. 182.

he sells out, and perhaps wants to move to California to live on his life's savings, he discovers that he must give the government a greater portion of his gains than he had expected". The injustice played on the taxpayer is not as great as might first appear. His gain is a long term gain and is decreased by fifty percent before the computation of the tax. The alternative tax protects the taxpayer against paying a tax of over twenty-five percent of the actual gain, if his gain is such as to bring him into this high tax bracket. The case of the abused farmer is definitely the exception, however, rather than the rule. A breakdown of capital gains by income groups[1] for the typical year 1939 indicates that taxpayers with incomes of over $25,000 receive ninety-six percent of the capital gains. Taxpayers with incomes of between five thousand to twenty-five thousand dollars receive less than three percent of the capital gains. While taxpayers with incomes of under $5,000 receive less than one percent of the capital gains.

It would appear then, that the farmer was not being treated unfairly after all, granted that the original promise that the gains accrued evenly over several

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1. Paul, R. E., (Former General Counsel of the Treasury), Address before the New School, New York City, January 30, 1945.

years was correct. But even this premise is attacked on the grounds that the gain may not have accumulated over the long period, but during a recent period, through factors beyond his control such as general business prosperity. The 1934 revenue act was based on the theory that capital gains accrued evenly over a period of time and provided for reductions in taxation with increased holding periods.

Use of Capital Gains and Losses to Produce Smallest Tax

Another special feature of capital gains and losses which has been brought to the attention of the public is that the taxpayer is entitled to use his capital assets to produce the minimum tax. To a large extent the taxpayer can select the most favorable time to take his gains and losses. One type of transaction, the wash sale, is no longer recognized for the taking of tax losses. A wash sale consisted of purchasing substantially identical stock or securities within thirty days before or after a sale and enabled a taxpayer to both realize a loss and retain his investment at the same time. This provision is sometimes evaded by selling the securities at a loss to a friendly buyer and repurchasing them after thirty days, producing

a fictitious loss.

In the depression years of the early 1930's taxpayers possessing many securities which had depreciated in value sold enough of these securities to offset any gains and profits they might have made. For example, J. P. Morgan and his partners sold a portion of their depreciated stocks and established deductible losses from their current incomes. This was perfectly legal, and although they probably had large cash incomes, they escaped paying any income taxes.[1] The present loss limitations would make reduction in taxes by this method more difficult, as capital losses for taxpayers other than corporations are limited annually to capital gains plus other net income or $1,000, whichever is less, and a loss carry-over provision for five succeeding years.

In the case of gifts to charities the taxpayer may use as a deduction the market value of the property donated.[2] This provision makes less expensive for persons of wealth the donation of capital assets that have increased in value, than a donation in cash.

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1. Groves, H. M., op. cit., p. 183.
2. Regulations 111, Sec. 29.23(c)-1.

It is actually possible for the taxpayer, in extreme cases, to enlarge his personal fortune by giving away assets with large capital gains rather than selling them at a profit. "...if a block of stock which was bought for $1,000 has risen in market to $7,000, then if the stock is sold and the 25% tax paid on the $6,000 capital gain, the taxpayer obtains a net proceeds of $5,500 after tax. But if the stock is given away to charity, the taxpayer obtains a deduction of $7,000 from his other income. If his top bracket rate is 80%, this will reduce his taxes by $5,600 compared to what they would have been had he held on to the stock. Thus he will end up $100 better off by giving the stock away than by selling it and keeping the amount by which the proceeds exceed the tax."[1]

Capital gains taxes may sometimes be avoided by presenting gifts to persons in lower tax brackets than the donor. The donor pays no tax on the capital gain, and the basis in the hands of the donee in case of capital gain is the cost or other basis as in the hands of the donor. Although a gift tax may be paid by the donor, this may not offset his income tax saving. On the other hand, where there is a capital loss I. R. C. Section 113 prevents minimizing taxes among members of a family who would make gifts to those who would receive the greatest tax benefit of items on which losses could be taken. Under this section the basis for computing loss is the lower of either the donor's adjusted basis, or the fair market value at the time of gift.

Payment of income tax on unrealized capital

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1. Vickrey, W., op. cit., p. 140

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Payment of income tax on unrealized capital

1. Vickrey, W., op. cit., p. 140

gains is avoided entirely upon the death of the taxpayer. Neither the deceased, the estate, nor heirs are ever taxed on the gains accrued. The decedent or his executor recognizes no gain.[1] The basis of the assets in the hands of the beneficiaries is the fair market value of the property on the date of death of the decedent; or its value on distribution within one year after death if the executor makes the election under Internal Revenue Code Section 811(j).[2] Although the income tax is avoided on capital gains at death these gains are not completely tax-free as the estate tax is computed upon the fair market value of property at the date of death, or an optional later date allowed by law.

Effect of Capital Gains and Losses Provisions on Revenue Yield of Income Tax

The income tax, upon which the Federal government is so largely dependent, is peculiarly affected by changes in business conditions. When the business cycle is in the upswing and money is easy, then revenues increase greatly. When the cycle is turned in the direc-

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1. Regulations 111, Section 29.162-1.

2. I. R. C. 113 (a) (5); 29.113 (a) (5)-1.

tion of a depression then revenues fall off greatly. This is due in part to the fact that the tax is levied progressively, but it is also due to a large extent to the inclusion of capital gains and losses in the income tax. For example,[1] in the year 1928, the amount of tax realized on capital gains was $576,000,000 which was almost as much as the tax realized on other current income. In 1931 there was an $89,000,000 reduction in taxes due to capital loss deductions as compared to the $335,000,000 tax that would otherwise have been paid on current income. Because of these large fluctuations it has been charged that the capital gains tax, because of emergence in inflationary periods gives the government too much revenue in good times when it does not need it, and reduces revenue in bad times when the government needs it most.[2] This is the same type of argument which is generally used against income taxes as a whole, and receives the same type of rebuttal. During times of inflation the government should tax heavily, and ease up on taxpayers during a depression period.

The present method of limiting the amount of loss that can be taken will tend to smooth the amplitude

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1. Schuitz, W. J., American Public Finance, Prentice-Hall, New York, 1942, p. 435.

2. J. Viner, Taxation and Changes in Price Levels, Journal of Political Economy, Vol. XXXI.

of revenues by reducing the losses that can be deducted from ordinary not income. Some persons feel that the government is guilty of sharp practice in taxing all capital gains but limiting losses that can be taken. This argument is rebutted by the fact that long term capital gains are given special preferential treatment, and that taxpayers can choose the time to realize their losses to result in the greatest tax benefit to themselves.

Effect of Capital Gains and Losses Provisions Upon Stock Market Transactions

It is sometimes stated that "the capital gains and losses feature of former federal income tax laws had a bad effect upon speculation".[1] The reasoning is that during a period of rising prices, taxpayers will refrain from realizing their profits to avoid heavy taxes. During a period of declining prices, taxpayers will sell and realize losses in order to obtain a reduction of taxes. The present tax law does not emphasize either of these undesirable features because of the 25% tax ceiling on gains and the limitation of losses. Although the 12½% rate in 1929 is said to have deterred

1. Groves, H. M., op. cit., p. 183.

many rich taxpayers from making sales of their securities it is said that the present twenty-five percent ceiling is less of a deterrent because the tax rates on ordinary income are proportionately much higher.[1/]

It is believed by some that the present ceiling of twenty-five percent tax on long term capital gains is too high. Mr. Franklin Cole, senior member of the firm Cole, Hoisington, and Company, Inc., investment counselors states that as tax rates are reduced in the future (and he anticipates tax reductions), capital gains taxes should be reduced. He proposes a schedule of:

Six months or more	25%
Nine months or more	20%
One year or more	15%
One-and-one-half years or more	10%
Longer periods	Further reductions

The statement is made by Mr. Cole thatinvestors, as a group, have aged and are conscious of death taxes. These aged investors have the fear that

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1. Tax Institute, Capital Gains Taxation, p. 57.

if death should overtake them shortly after paying a tax rate of twenty-five percent on their gains, and death taxes further reduce the estate, then the size of the estates will be greatly diminished. But they are also afraid of a repetition of 1929. A reduction in capital gains rates would encourage these aged investors to sell their holdings and put their money into government securities.

He states further[1/] that a reduction in the capital gains rate would enable taxpayers to realize profits on securities on which they have made large paper gains, and hence free the flow of capital. "We have a block of 800 shares of a glass company, which is selling for 44. The stock has experienced a phenomenal improvement in price. The cost was 8, so we have a long term gain of $36. The capital gains tax is $9. On advice to sell the investor states: 'That is a fine stock. You think it overpriced and my react sharply, but believe that later on, say by the latter part of 1947, it will again be in the clear. Do you think we can repurchase the stock at 36 should we de-

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1. Tax Institute, op. cit., p. 57.

cide to sell at the present market price?' Of course I must reply that I cannot make such a guarantee, in which event the investor refuses to sell and sits tight."

Dr. Roy Blough, Director of Tax Research of the Treasury Department questioned Mr. Cole[1] on whether a low capital gains rate would tend to increase the number of speculative transactions on the market, and hence create a rise in stock market prices. Mr. Cole agreed that it might bring speculation into the market but added, "The market is so broad and vast and big that if speculation kicks prices a little too high, there are always correctives that will shake it down."

Professor Harold R. Groves of the University of Wisconsin expressed the opinion that light taxation of capital gains encouraged securities purchases for gain in the value of the security, rather than for purposes of deriving an income from the dividends. He deplored the consequences of this type of trading for the following reasons:

It encourages valuation of stocks by guessing at the trend of the market rather than their inherent

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1. Tax Institute, op. cit., pp. 61-63.

value as income producers. This type of pricing on the market will aggravate both booms and depressions.

High turnover of stock, which would be encouraged, would result in giving further power to corporate management, rather than the stockholder. "...private enterprise is more defensible on the philosophy of trusteeship than on the basis of ownership dependent upon gambling in values."

Consequences of Loss Provisions on Stock Market Transactions

It has often been repeated that the capital gains and losses provisions aggravate both booms and depressions. As regards losses, a reward is given to the taxpayer, in the form of a tax deduction if he realizes his loss. During a declining period large numbers of persons may seek to realize losses to obtain the tax benefit. This additional selling wave tends to further depress the market.

In addition to this cyclical type of movement, there is seasonal movement to realize losses at the end of the taxable year in order to reduce the amount of tax liability. During this period, consequently, prices (on the average) fall. At the beginning of the following taxable year the demand for these stocks improves and prices are raised again.

Under the present tax laws (in effect for the taxable year 1946) the magnitude of the losses allowed is relatively small, tending to reduce the above mentioned fluctuations, but they still represent ability to cause real fluctuations. The law allows capital losses up to the amount of capital gains plus $1,000 of ordinary income with a carry-over provision for five succeeding taxable years. Since the taxpayer is free to pick the time when he can take his losses, he can use his losses to reduce his taxes as much as possible, and does so to such an extent as to cause changes in the price levels of the securities markets.

Another purpose of the capital loss limitation is to prevent tax avoidance on other income through manipulation. If no loss limitations were in effect, and the present favorable rates were granted to long term capital gains (over six months), then a taxpayer who was willing to speculate could obtain tax savings. All investments on which there was a loss could be sold before the expiration of the six months holding period, and losses allowed in full for tax purposes. Investments upon which there was a gain could be held for more than six months and fifty percent of the gain taxed. If the taxpayer had equal amounts of losses and gains he would get a tax deduction on his other income of fifty per-

cent of his losses.

Consequences of the Six Months Dividing Line on Stock Market Transactions

The apparent purpose of the six months holding period as a differentiation between the long and short term transactions is to distinguish between the speculative and non-speculative type of transaction. In the past holding periods of varying lengths of time have been employed to differentiate between various types of transactions. For example, in our early income taxes during the Civil War, in 1864, Congress limited the taxation of profits on the sale of real estate to that which was purchased during the year.[1]

In his argument for the reduction of the tax after a short holding period such as six months Mr. Cole stated, "I would not want the tax to harness me where it would be the controlling factor rather than other factors of greater importance."[2] Mr. Ruml, also in favor of the six months holding period, stated in the same vein, "Six months ago, for example, the expectations for unemployment and work were quite different from what they are today. In six months from now we

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1. Ratner, S., op. cit., p. 86.

2. Tax Institute, op. cit., p. 89.

shall find out whether the present prophets are right. At that point it would be a very good thing that some people should be able to buy as an investment or that other people, feeling differently, should be able to sell as investors."[1]

Mr. Cole was of the opinion that risk, or venture capital was aided by a short holding period. New Capital requirements are generally filled by way of stock rights. A short holding period is more of an inducement to the investment than the long period, as the investor wishes to be free to move in the light of economic changes.[2] In any event venture capital generally proceeds from the existing market, and is facilitated by liquidity of securities held by investors.

The practical working effect of the six months holding period on the professional trader is explained.[3] Floor traders are not ordinarily long term investors, but rather pure speculators. They buy and sell securities in an effort to make quick gains. Their useful function in the market is to "assume certain risks, to support certain stocks, either by buying or selling, in an effort to stabilize prices ... the professional

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1. Tax Institute, op. cit., p. 89.

2. Ibid., p. 87.

3. Ibid., pp. 83-87.

trader known as the in-and-outer who is willing to accept a one-half point to one point profit or less". This person will remain a floor trader until he has realized all the short term capital gains that he can acquire within the 25% tax bracket. When this point is reached, rather than speculate in the higher tax brackets, this person avoids his function as a trader and becomes a long term investor striving for long ter capital gains on which he will pay a tax of 25%. This 25% mark "brings out the positive brake on sheer speculation". The problem of having this person continue in his role as trader cannot be solved by merely lengthening the holding period from six months to a longer holding period as the trader makes few committments that he will hold for six months.

Chapter VI

CONCLUSIONS

In spite of many changes in the capital gains and losses provisions of the Federal Income Tax, the problem of equitably taxing this income is still a matter of debate. The foregoing chapters have perhaps shed light on some of the issues, but do not solve the problem nor propose a magical remedy.

It has been stated that a well designed tax system should provide an adequate yield, should be simple and economical in administration, and should be fair.[1] In the case of capital gains and losses these three canons may work at cross purposes.

For example, as has been mentioned earlier in this thesis, capital gains and losses are subject to severe cyclical fluctuations. In periods of decline, capital losses if allowed in full could wipe out the tax on all capital gains plus a large part of ordinary income. In order to provide an adequate revenue yield restrictions were placed on the amount of capital loss that could be utilized for tax purposes. This brought forth the charge that the government was not fair in

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1. Magill, R., The Impact of Federal Taxes, Columbia University Press, New York, 1943, p. 6.

taxing gains in full but not allowing the losses in full.

It is also argued that a tax should be simple and economical in administration. The capital gains and losses provisions are quite complicated as compared to the provisions of other taxes. These excessive complications arose from the desire on the part of legislators to avoid hardships on particular taxpayers and to plug loopholes in the income tax law.

Although a tax should be fair, it is difficult to determine what is meant by that term, except from one's personal point of view. "Abstract equity may look like practical discrimination when applied to the particular case."[1/]

Since we consider capital gains as income and as such include them within the income tax, it behooves us to study the various considerations to determine the best method of taxation. This income is generally recognized as having peculiar qualities which require that it be given special tax treatment, although some dispute this contention. Some of these qualities were discussed in Chapters I and V. In addition statistics were offered to indicate that capital gains occur with greatest frequency in high income groups, and that the

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1. Magill, R., op. cit., p.8.

largest percentage originate from securities transactions.

If we were to set up an ideal system of taxation of capital gains we should first decide the purpose of the tax. Some of the problems might be: Should we try to stimulate securities markets activities; depress securities markets activities; lessen fluctuations in securities markets prices; favor long term investments; encourage speculation; retain the progressive character of the income tax; attempt to get the largest revenue yield possible; regularize revenue yield?

Under a highly progressive tax system, and with tax rates up to 85½% of net income, taxpayers in the higher income brackets tend to divert their activities into procuring income which is not taxable at these high rates. Numerous methods have been employed, and although several of these are no longer allowed to the taxpayer some may still be utilized. To the extent that tax exempt and tax favored income is employed, the highly progressive nature of the income tax is avoided.

The preferential rates attached to long term capital gains are especially beneficial to high income taxpayers. If a taxpayer in the highest tax bracket

earned an additional $1,000 of ordinary income he could retain for himself only $110. But if the $1,000 were a capital gain he could retain $750 of this amount.

The adjustment, then, of tax rates and alternative taxes for capital gains, in conjunction with the holding period, can affect the holding period of securities, while at the same time affecting the progressive structure of the income tax.

There is a minimum holding period required for a transaction to be classified as a long term capital gain. If no holding period were required to realize tax benefits for gains, then the securities markets would tend to become more speculative. A requirement for a very short holding period before receiving tax benefits would tend to result in holding of securities for at least that short period. An extremely long holding period with tax rewards in the distant future would not be a great incentive to holding in a rapidly changing market. A series of holding periods, spaced at short intervals and with increasing tax benefits would tend to cause the taxpayer to hold his securities for a long period.

Hence by regulating the holding period for tax purposes we can, to an extent, vary the length of

time the taxpayer will hold his securities.

The effect of taking into account only a percentage of net long term capital gain is to give to all taxpayers who hold capital assets with a prospect of gain an incentive to hold their assets for the long period, hence reducing the speculative nature of capital markets. When the holding period has elapsed, there is a stronger tendency to sell and realize any profits at a reduced rate than at regular rates for ordinary income. There is a tendency for taxpayers to convert their ordinary income, whenever possible, into long term capital gains and hence enjoy the benefit of a reduction in the tax. The alternative tax of twenty-five percent of the excess of actual long term capital gains over short term capital losses accentuates this result. It is to be observed that the incentive of the present twenty-five percent alternative tax ceiling on long term capital gains applies only to persons of high incomes who would otherwise pay higher rates on this class of income.

Capital losses may be allowed in full, in part, or not at all. Capital losses, if allowed in full against all types of income during a declining

period could seriously disrupt the revenue from the entire income tax, on which the government is so largely dependent. Securities and other capital assets would be sold on the market merely for the purposes of tax deductions, and these sales would tend to depress prices further. Capital assets on which a loss had been incurred at the end of the taxable year would be sold for the purpose of reducing the tax, causing a seasonal fluctuation in capital asset prices. Furthermore, as explained in Chapter V, even if only short term losses were allowed in full, while long term gains were treated favorably, it would be possible to manipulate purchases and sales simply for the purposes of obtaining tax deductions.

If capital losses were not allowed against any kind of income, including capital gains, then this would reduce the fluctuations in revenue of the income tax, eliminate the deterrent effects upon the market associated with taking of tax losses, and encourage longer holding of securities. However, this would be obviously unfair to persons who could not offset their gains with their losses, and would reduce the desirability of securities market transactions and other capital asset transactions. Prices of good securities would tend to decline, and new enterprises would find capital

difficult to acquire.

Limiting capital losses to capital gains presents a compromise. Since capital losses could not be deducted against ordinary income, taxpayers would not sell for tax benefits any amount greater than that necessary to cancel capital gains. The capital market would not tend to decline as severely as if full deductibility had been allowed. Governmental revenue would not tend to fluctuate as severely as if full deductions were allowed because ordinary income could not be cancelled by capital losses, and also because the prices of capital assets would not tend to be as depressed as if full deductibility had been allowed. It would seem fair, particularly if taxpayers had the benefit of favorable rates on capital gains, to limit the deduction of capital losses, since taxpayers are generally free to choose the time to take losses to result in the greatest tax benefit to themselves.

Limiting capital losses to capital gains plus a certain amount of ordinary income would seem to be a further compromise of the above. It might be more fair to the taxpayer to be able to deduct a larger capital loss, or to deduct a capital loss in the absence of capital gains, but all the disadvantages mentioned in connection with limiting capital losses to capital

gains would be present.

A carry-over provision for capital losses for a period of several years has the advantage of being fair to the taxpayer who suffered large losses. This provision tends to prevent large revenue losses during declining periods, and spreads them over later years. Where there is a limitation in the amount of deductibility of losses a taxpayer may reduce his tax in his highest surtax brackets for a period of several consecutive years. This may result in a lower total tax revenue to the government than if the taxpayer had been allowed a deduction to the extent of his entire income, or a portion of his income, in the year of loss. The result on a declining market of such a provision would be to accentuate its decline. Taxpayers would tend to dispose of their capital assets more readily than if there were no carry-over provisions.

Under the present laws long term capital losses (assets held more than six months) of taxpayers other than corporations are taken into account at only fifty percent for the purpose of determining net gain or loss. Apparently the reasoning is that if it is fair to account for long term gains at fifty percent, then it is fair to account for long term losses at that

rate also. Revenue losses are not so great under such a provision as they would be if losses were deductible in full. Yet if the purpose of the law is to encourage long term holding of capital assets, this unfavorable loss provision seems to be a deterrent.

The term "capital assets" is defined in Chapter III, and assets of many descriptions fall within the definition. In Chapter I it is stated that the great majority of capital gains and losses arise from stock market transactions. If it were desired, securities transactions and other types of capital transactions could be separated into two or more different classifications and each given special tax treatment. Although this would further complicate the law, other considerations might make this desirable.

Securities markets transactions constitute the bulk of capital gains and losses transactions. These transactions have been given special treatment under prior revenue acts. Since it has been charged that the law increases the amplitude of both gains and declines, it would be appropriate to segregate these transactions from other capital transactions and treat them so as to minimize the revenue fluctuations to the government, while at the same time minimize the effects on the market. Declines could be checked by reducing

the tax benefits from the realization of loss, and booms could be checked by increasing the rates of capital gains taxes. Other provisions such as holding periods, carry-overs, etc. could be utilized to help obtain the desired result.

At the same time, if desired, home owners and others might be given special preferential treatment. Perhaps this special treatment might apply when the asset had been held for a period of many years; or if one asset was sold at a gain and a similar asset purchased within a reasonable period of time.

Since the revenue yield of capital transactions other than securities transactions is relatively small, and since their markets are not generally so volatile as securities markets, special tax treatment might be applied in many cases which was primarily in the interests of equity.

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Capital gains and losses as affected by the federal income tax

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